SOCIALLY RESPONSIBLE RESTRUCTURING AND FIRM'S PERFORMANCE:
EVIDENCE FROM CHINESE ENTERPRISES

Liangrong Zu

Thesis submitted to the Nottingham University Business School for the Degree of Doctor of Philosophy

June 2006

Abstract

This study empirically explores the phenomena of corporate social responsibility (CSR), corporate restructuring and their relationships with firm's performance in the context of economic reform in China from three main perspectives: the study begins with investigating how Chinese managers perceive CSR, to what extent, managers' attitudes influence their behaviours in restructuring, whether those who are more in faviour of CSR may engage in more socially responsible restructuring; then the study examines the relationship between socially responsible restructuring and firm's financial performance, and the study also analyzes a case study of enterprise restructuring in China defence industy.

The three perpectives covered by the study are logically interrelated. It is assumed that by understanding an individual's attitudes toward something, we can predict the individual's overall pattern of response to the object, therefore, an assessment of a manager's attitude toward CSR may provide an indication of the manager's predisposition to respond in a particular way to CSR. Thus, different attitudes toward CSR (in faviour of or against) may result in the different actions (socially responsible or socially irresponsible), and different behaviours may lead to various firm's performance. By analyzing the case study, we can have comprehensive and deep insight into the CSR issues, and have a fuller understanding of the process of socially responsible restructuring in China.

The result of the study provides more evidence for the theories about relationship between CSR and firm's performance. The result suggests that there be a positive relationship between attitude and behaviour with regard to CSR, socially responsible value-oriented managers pay more attention to social issues in restructuring. The result also shows that there is a positive association between CSR and financial performance, more social responsibility leads to better financial performance, and financial performance drives socially responsible performance in restructuring. The result further reveals that after restructuring, firms didn't significantly improve profitability as expected by government and management.

Acknowledgements

I am grateful to all the people who have directly and indirectly contributed to the success of my PhD dissertation.

I would like, particularly, to express my sincere gratitude and appreciation to my supervisors: Dr. Olga Suhomlinova and Dr. Lina Song, for the time and efforts they have devoted to my PhD study. The advice, guidance and encouragements they have given have been invaluable in my academic career. I have learnt so much from the frequent discussions that I had with them during the course of my PhD study. The guidance and advice they have made really have helped me to acquire in-depth knowledge of the subject matter and of the research methodology. I wouldn't successfully complete the PhD research project without their concerted efforts and assistance. I owe a special debt to them.

I would also like to thank Professor Jeremy Moon, Director of International Centre for Corporate Social Responsibility and Ms. Anna Soulsby at the Nottingham University Business School for their insightful comments and advice on the structure, contents and methodology of my thesis.

I thank University of Nottingham for financing this research and International Training Centre of the ILO for providing the opportunity for me to continue a doctoral study. I am particularly appreciative of the cooperation and assistance provided by China South Industries Group Corp. who gave me the opportunity to carry out the field visits for the case study, and test and validate my survey questionnaires.

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Chapter 1 Introduction

The study of corporate social responsibility (CSR) and its relationship with firm's financial performance has been the hot topic in the academic world, however the interests of researchers have more focused on investigating the phenomena of CSR in the developed countries than in the developing world. Little study has been done in investigating the relationship between socially responsible restructuring and financial performance.

This study intends to empirically explore the phenomena of CSR, enterprise restructuring and the relationships with firm's performance in the context of economic reforms in China from the three important perspectives. The first investigates how Chinese managers perceive CSR, whether managers' attitudes toward CSR influence the extent of managers' socially responsible behaviours in restructuring. The study also examines relationship between socially responsible restructuring and financial performance in the listed firms. Finally the study ends up investigating the case study of enterprise restructuring in China defence industry.

The three perpectives covered by the study are logically interrelated. It is assumed that by understanding an individual's attitudes toward something, we can predict the individual's overall pattern of response to the object, therefore, an assessment of a manager's attitude toward CSR may provide an indication of the manager's predisposition to respond in a particular way to CSR. Thus, different attitudes toward CSR (in faviour of or against) may result in the different actions (socially responsible or socially irresponsible actions), and different behaviours may lead to various levels of firm's performance. By analyzing the case study, we can have comprehensive and deep insight into the CSR issues, and have a fuller understanding of the process of socially responsible restructuring in China.

The study also examines whether the firm's performance was improved after restructuring as expected by government and management, and identifies the sources that influence changes in financial performance after restructuring.

This study was motivated by the desire to provide a convincing rationale for managers to adopt socially responsible practices, assist non-shareholder groups in their battle against corporate decisions that ignore social stakeholder interests and contribute to the academic arguments claiming a broad "stakeholder theory" is better than shareholder theory.

This is the first study devoted to empirically exploring the phenomena of CSR in the People's Republic of China, particularly, the relationship between socially responsible restructuring and firm's performance. The result of study provides more evidence for the theories about relationship between CSR and firm's performance, and contributes to the growing knowledge in CSR by using the specific Chinese case. The study bridges a gap between the research on relationships between restructuring, CSR and financial performance in transition economies. The previous researches on CSR used to concentrate on the cases of Fortune500 or S&P500, and to be dominated by the researches in the developed world. The study suggests multiple dimensions for measurement of corporate social performance based on the stakeholder theory.

This chapter will analyze the phenomena of SOE restructuring and privatisation in recent years in China, particularly the issues and problems arising from the restructuring, and the social impact of restructuring on the stakeholders. Against the background and context, the research questions will be developed and justified afterwards.

1.1. Introduction

State-owned enterprise (SOE) reform has been regarded as the central link in China's economic reforms and strategic restructuring. Since 1980s, SOE reform has gone through different stages such as delegation of powers and interests, instituting the contract operational responsibility system, and establishing a modem enterprise system. China's government has been determined to proactively restructure the overall SOE sector, intensify enterprise reform, and speed up the pace of privatization of SOEs by selling off SOEs to private and foreign investors. As Li Rongrong, Chairman of State Assets Supervision and Administration Commission (SASAC), emphasized that after more than twenty years of market-oriented reforms, especially after the fast growth of the past ten years, and in light of 16th Party Congress, it is time to accelerate the pace of selling off SOEs to private domestic and foreign investors (Cheng 2003).

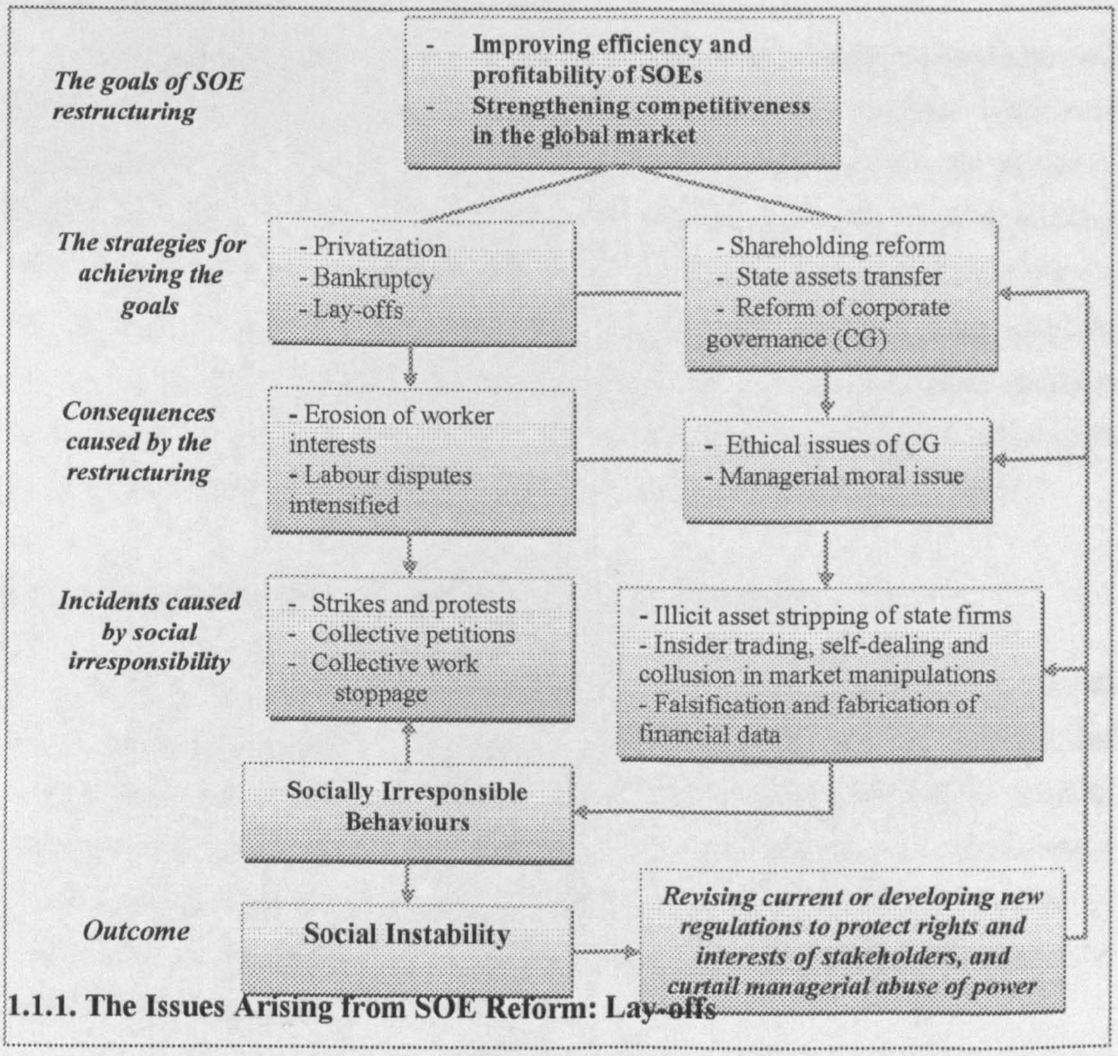
Since 1997 when the 15th Chinese Communist Party Congress (CCPC) advocated a radical transformation of state-owned enterprises with the new restructuring strategy, i.e. 'Grasp the big and release the small' (*zhuada fangxiao*), SOE reform stepped up to a new stage, numerous small- and medium-sized SOEs have been converted into shareholding companies with mixed public and private ownership, sold or leased to private individuals (either domestic or foreign), merged with one another, or just allowed to go bankrupt. The state was carrying out the restructuring program for a twofold purpose, on the one hand, the programme was intended to improve the efficiency and profitability of SOEs by reducing excess capacity, shedding surplus labour, lowering debt loads, and upgrading productive capacity; and on the other hand, it is to transform SOEs into market players by changing their ownership and management so as to improve the competitiveness in the global market.

The economic effect of the restructuring programme has had great impact on enterprise development and growth, but its social consequences are even troublesome. Figure 1-1 shows that one of these consequences, as some scholars already note, is a rapid transfer of state assets into the hands of managers and other private individuals (Ding 2000), and other ethical issues emerging in corporate governance. Another consequence is that the restructuring program has led to a systemic erosion of labour interests, as it has been accompanied by severe measures against workers, including collective layoffs, deprivation of benefits, ruthless labour rights abuses, and brutal working conditions. Lacking effective state protection as well as organizations of their own, workers have become increasingly vulnerable to the "whip of the market" and to despotic managerial power (Lee 1999a).

These problems have brought about social turmoil, and influence the pace of SOE reform and severely impaired social instability. The following sub-sections will explain and analyze the issues and problems illustrated in Figure 1-1.

In 1997, the 15th CCP national Congress and the Central government required that the loss-making large and medium-sized SOEs must get out of the debt crisis and improve their profitability by setting up modern corporate system within three years from 1998 to 2000, mainly in the industries such as coal, nonferrous metal, sugar, textile, iron and steel, and defence industries. Especially since 1999, when the government adopted the policy and strategy of SOE restructuring "Laying off redundant workers and downsizing employees to improve efficiency and profitability",[1] SOEs have been encouraged to terminate and lay off redundant workers and employees on a large scale. The widespread and aggressive enterprise restructuring has become more prevalent, particularly, downsizing has been regarded as the first resort to cut costs and improve economic performance.

Figure 1- 1 Process and Impact of SOE Restructuring in China



1.1.1. The Issues Arising from SOE Reform: Lay-offs

The two quantitative changes were most visible during the latter 1990s - a rapid decline in the number of SOEs and declining employment within surviving SOEs. From

[1] "Decision on Major Issues Concerning the Reform and Development of SOEs", China News Agency, 26 September 1999.

1998 to 2003, the number of SOEs was significantly reduced by 40% from 238,000 to 150,000, and the stated-owned SMEs were down from 245,000 to 145,000, 85% of state ownership was transformed into different system through restructuring, spin-off, mergers and acquisitions, sell-off and shareholding corporative reform.[2] State-owned SMEs have been the biggest beneficiaries of restructuring programme, 80% of national-level SOEs and 60% of municipal-level of SOEs had been privatized. By 2003, 4223 large and medium core SOEs in China were transformed to shareholding companies with diversified shareholders (Andrew 2003)

The restructuring has had a profound impact on employees, communities and society as a whole. Workers and employees become the forefront victims of restructuring. It was reported that the lay-offs in SOEs increased from 5.9 million in 1998 to 6.6 million in 2000, and the total laid-ff workers accumulated to 28.43 millions within the period of 1998-2003 (Ministry of Labour & Social Security 2003). Some 4.1 million workers were laid off from SOEs along with 2 million from non-state enterprises by the end of 2002. The re-employment rate for laid off in SOEs slid from 42% in 1999 to 36% in 2000, and 30% in 2001. The registered jobless in urban areas reached 7.1 million, or 4% of overall labour force by the end of 2002 (Xie 2003).

1.1.2. Social Consequences of SOE Reform: Labour Unrest

One of the consequences of the radical restructuring coupled with mass lay-offs has intensified and sharply increased the labour disputes between workers and management over a variety of issues, ranging from job contracts, wages, benefits, pensions, and unemployment compensation to working conditions, and led to labour unrest across the country. According to official statistics, there were 226,391 cases of labour disputes happened in 2003, and an increased 21 % over 1996, and 801,042 workers have been affected. [3]

Since the mid-90s, the reports on workers' protests arising from enterprise restructuring have frequently appeared in the media. Chen's study (2003) shows that the labour protests in question reflect workers' strong opposition to restructuring process

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[2] South China Morning Post, Nov. 20 2003

[3] China Labour Statistical Yearbook, various versions.

that excludes their participation, ignores their interests, and infringes their rights.

National statistics on labour protests are not available, but scattered reports from both the official media and the media outside China reveal that restructuring is conflict prone. Some local authorities have openly admitted it. For example, a report by the Provincial Trade Union of Henan indicates that 37.7% of protests in the province in 1997 resulted from the infringement of workers' legal rights during restructuring.[4] The Shanghai Municipal Trade Union also attributes some large-scale collective contentions to restructuring.[5]

Table 1-1 presents some striking incidents happened over the past few years. The case in 1997 was a starting point when four thousand silk workers in Sichuan province demonstrated outside government offices demanding unemployment benefits when their factories were closed. The reports of workers' protests over sudden redundancies, plant closures, bankruptcy and takeover about which they have not been consulted and about the non-payment of unemployment allowances or pensions have become extremely common in many parts of urban China since 1997. One of the most influential events happened in March 2002 when tens of thousand of workers went on street to protest over pay, layoff and pensions in the cities of Daqing, Fushun and Liaoyan (Robers, Einhorn, and Balfour 2002).

Table 1- 1 Incident of Workers' Protests Arising from Restructuring

Year	*Place*	*Cause*	*Outcome*
06.2000	Shanghai Second Leather Shoes Factory	Managerial corruption in the process of shareholding restructuring	Over 100 workers went on a collective petition from June to August 2000.
01.2001	Dyeing and	The closure of the factory	The furious workforce

[4] Henan Sheng Zongonghui Bangongshi (The General Office of Henan Federation of Trade Unions) (1999) "Analysis of Workers' Street Demonstration in Henan Province during 1998 China Labour Bulletin, No.50, available online: *http://www.china-labour.org.hk/99122/henan_demos.htm*

[5] Shanghai Shi Zonggonghui Yanjiushi (Research Office, Shanghai Municipal Federation of Trade Union) (1999) "A Study on the State of Labour Relations during the Change of Property Rights", Pp353-359 in Research Office, ACFTU, ed. 1997, Survey of the Status of Chinese Staff and Workers in 1997. Beijing, Xiyuan Chubanshe.

	Chemical Fertilizer Factory *(Jilin Industrial Chemicals Group)*	owing to manager corruption led to 4000 workers out of jobs. The corrupt and murky deals led to direct losses of 14 billion Yuan in 1998 and 13 billion Yuan in 1999.	promptly blocked a local public highway for three days to protest at the sudden closure of the factory.
03.2002	Oil Companies in Daqing, Fushun, and Liaoyang in China Northeast	5000 workers were laid off from state-owned oil firm, with unpaid benefits and back pay due to the managerial corruption.	Over 10,000 workers went on street to protest and surround government buildings in the cities
09.2002	Chuandong Oil Exploration & Drilling Company in Chongqing	The retrenched workers demand unemployment allowances, adjusting the premium for their pensions and job placement or reinstatement for retrenched young workers.	Daily sit-ins outside the company building.
11.2003	Xiangfan Automobile Earing Company Ltd in Hubei Province	The privatization of the former state-owned company resulted in job losses of workers.	10,000 Workers blocked roads and railway lines across the city to force the government to guarantee their rights and interests.
04.2003	Sichuan Dongcai Insulating Material Enterprise	Illegal buy-out of the profit - making SOE by management at a lower market price brought about state assets loss.	More than 1,000 workers launched a strike to stop the restructuring programme.
09.2004	Tianwang Textile Company, Shaanxi Province	The new owner of China Resources, a Hong Kong-listed firm after acquisition, imposed the unfair contracts on the workers.	6,800 textile workers went on strike and protesting for about seven weeks.
09.2004	The Chemical Plant in Dazhou in Sichuan Province	Unfair share purchase and allocation scheme between employees and management, and lack of communications with workers and the workers' committee in restructuring.	Over 100 workers blocked the entrance to the factory's dormitory and demanded the city government to terminate the factory's allegedly illegal restructuring plan.

Source: Business Week, European edition, April 8 2002; Chen (2003), and China Labour Bulletin, in Hong Kang, various versions, (www.china-labour.org.hk).

The "injustice" commonly complained about by workers is their total exclusion from the restructuring process. In many enterprises, as in all the cases as shown in Table 1-1, management made decisions on restructuring behind the scenes, deliberately kept knowledge of them from workers until they were formally announced. While official policies stipulate that in formulating a major restructuring scheme, especially when it will affect workers' interests, workers must be consulted,[6] management seldom brings such issues up for open discussion in enterprises. Managers argues that open discussion would only create a mess and hinder restructuring measures since restructuring almost inevitably alters workers' existing economic status. But very often, the move to keep workers away from decision-making indicates that managers have something to hide - since many of them have taken advantage of restructuring for their own private benefit.

1.1.3. Ethical Issues in Corporate Governance

As a result of the more rapid pace of corporatization and privatization of SOEs since the early 1990s, corporate governance has assumed an increasing prominence in the reform agenda as government tried to promote enterprise performance and to look after its ownership stakes in various forms. The widespread and persistent financial distress experienced by many SOEs has added to the urgency of establishing the country's institutional framework for corporate governance.

Corporate governance is concerned with the processes by which organizations are directed, controlled and held accountable; it requires balancing the interests of various stakeholders and society as a whole with economic goals of the organization (Bonn and Fisher 2005). China's attempt to develop a modern corporate sector in the last decade has been conducted under the government's primary goal of raising productivity and maintaining political stability and economic growth. Despite the fact that the traditional SOEs provided nearly cradle-to-grave services to most urban workers and their families, their transformation into corporate entities to compete in open markets has basically been a technical exercise of getting the prices right and making the enterprises financially viable. As a result, opportunistic and strategic behaviour by managers to advance their interests at the expense of the company's shareholders and other stakeholders has been a major governance and ethical issue. Figure 1-1 shows that such behaviour has even taken the form of illegal activities such

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[6] For example, according to a document issued by the Ministry of Labour and Social Security regarding the enforcement of the Labor Law, an enterprise must notify the union and workers of the layoff play 30 days in advance. The union and workers have the right to express their opinions about the plan and revise it (see Zhongguo gongyun xue yuan gonghi xi, 2000:231).

as looting of company assets and various forms of corruption within and outside the company, weak protection of shareholders, insider trading, self dealing and collusion in market manipulation; falsification and fabrication of financial data (Tam 2002).

These opportunistic and irresponsible behaviours often take place in the restructuring, due to poor-quality auditing, manipulated figures for asset evaluation, lack of transparency and standards in property right transactions. In terms of illicit assets stripping of state assets, some executives took the restructuring as the entire withdrawal of the state from competitive sectors and advancement of the private sector. They were aggressive about the state asset sales, some measures employed during the process infringed the lawful interest and rights of the owners, creditors, and employees. Managers also have taken the chance of selling state assets cheaply and taking them over as personal property.

One of the cases in Table 1-1 shows that in Sichuan, Dongcai Insulating Material Company was a profit-making SOE, in April 2003, the firm's management attempted to privatize the enterprise through management buyout (MBO), and it was approved by its supervisory ministry and the local authorities. The firm's assets were worth over 90 million Yuan (11.1 million dollars), but the management tried to buy out the factory at as much lower price as possible. Thus, they worked with their own accountanth to manipulate the evaluation process, excluding the workers' congress in the process. As a consequence, the value of firm's assets was assessed as only 30 million Yuan (3.7 million dollars), but the management brought out the firm at 60 million Yuan (5.5 million dollars), the state lost about one third of its assets. The workers' strike and protest was trigged by the the irresponsible behaviour. The collective action eventually forced the local government to intervene, and the proposal was aborted.

One of other ethical and moral issues is managerial corruption; it is also another major incitement to workers' protest, especially when workers perceive it as a serious encroachment on their interests. When converting their business to a shareholding company, the management of Shanghai Second Leather Shoes Factory put forward a proposal that allowed only managerial personnel to hold shares and denied workers' right to do so. The management also hid information on factory assets and profits from the workers (Chen 2003).

In terms of protection of shareholder rights, Table 1-2 and 1-3 show that in the restructuring transactions, 172 listed firms violated the security laws and regulations between 2000 and 2004 because they disclosed false information or failed to disclose it timely and accurately, falsified and fabricated financial data to the shareholders. 178 listed firms in both Shanghai and Shenzhen Stock Exchanges were punished by China Security Regulatory Commission (CSRC) and other authorities between 2000 and 2004.

Table 1- 2 Incident of Infringing Interests of Stakeholders by Listed Firms between 2000 and 2004

	No. of firms	*% of total firms*
Not timely disclosure of important events	79	45.9
Incorrect performance prediction or delayed	48	27.9
Falsification and fabrication of financial data	45	26.2
Total	172	100

Source: China Security Regulatory Commission *(CSRC) online database: data.cninfo.com.cn; Shanghai and Shenzhen Stock Exchange*

Table 1- 3 Listed firms Punished by CSRC 2001-2004

	Shanghai		***Shenzhen***	
	Cases	*No. of listed firms*	*Cases*	*No. of listed firms*
2001	18	841	38	548
2002	18	841	26	554
2003	19	844	19	551
2004	20	668	20	450
Total	**75**		**103**	

Source: China Security Regulatory Commission (CSRC) online database: data.cninfo.com.cn; Shanghai and Shenzhen Stock Exchange

BBC News (2001) also reported that in 2001, the CSRC found that half of 56 companies that issued shares on the Shenzhen Stock Exchange misled shareholders; these companies advertised new shares to raise funds to expand their businesses, and then ploughed the money into stock speculation.

Some local governments in collusion with enterprise management have been rushing to sell small SOEs or even profitable large and medium-sized ones by administrative measures, even worse, some managers and directors have seized the opportunity to make up fraud accounts and engage in illegal deals in the disguise of “selling enterprises” and have been putting state assets into their own pockets (China

Daily 1998). Thus, it consequently hurts SOE reform, stakehoders' rights and interests, and severely influences social stability.

1.1.4. Reactions to Social Impact of Restructuring

As being seen from the above sections, the socially irresponsible behaviours have resulted in severe problems of social instability, and a wide range of stakeholder reactions such as labour protests and strikes. It may slow down, and in some cases, stall the restructuring. This fact has been increasingly recognized by governments, enterprise management and academic researchers. Larry Lang, professor of the Chinese University of Hong Kong, over the past years, has written many articles targeting alleged wrongdoings of SOEs executives who abused their rights and powers to seek personal gains in SOE restructuring, and suggested that authorities suspend the large-scale selling of state assets until it builds an efficient regulatory scheme. His remarks have aroused public concerns about the loss of state assets during the SOE restructuring and related legal loopholes (China Daily 2004).

Corporate stakeholder theory (Cornell and Shapiro 1987) also suggests that a firm must satisfy not only stockholders and bondholders, but those with less explicit, or implicit, claims. The stakeholder theory further contends that the value of a firm depend on the cost not only of explicit claims but also of implicit claims. If a firm does not act in a socially responsible manner, parties to implicit contracts concerning the social responsibility of the firm may attempt to transform those implicit agreements into explicit agreements that will be more costly to it.

If a firm fails to meet promises to government officials in regard to actions that affect workers and other stakeholders, government agencies may find it necessary to pass more stringent regulations, constituting explicit contracts, to force the firm to act in a socially responsible manner. Moreover, socially irresponsible actions may spill over to other implicit stakeholders, who may doubt whether the firm would honour their claims, thus, firm with an image of high corporate social responsibility may find that they have more low-cost implicit claims than other firms and thus have higher financial performance (Cornell and Shapiro 1987).

China's Supreme People's Court (SPC) promulgated a new regulation in early 2003 to deal with the issues arising from the irresponsible enterprise restructuring involving evasion of debts, wilful concealment and omission of debts, which have seriously impaired the interests of stakeholders such as employees, creditors, and business communities that have stake in the enterprises (China Daily 2003). In December 2003, the Chinese government issued another document to crack down on irregularities or malpractice in restructuring SOEs, and relevant policies have been put forward to regulate the approval of an SOE restructuring programmes, checks of company assets, audits, assets evaluations, property trade, pricing and payment in the guideline (BBC Monitoring Asia Pacific 2003). The guideline emphasizes the protection of employees' rights when the company starts restructuring. For example, the restructuring of an SOE, especially, to transform it into non-state enterprises, has to be discussed at the conference of workers or workers' representatives. The company will not start the procedure until it reaches an agreement with workers about their pay and benefits after restructuring, such as salary, health care insurance and housing funds. Payment of a state-owned property trading deal will be first used to pay compensation to lay off workers, defaulted salaries and social insurance premiums.

The rigid rules have been imposed on MBO (management buyout) in SOE restructuring (China Daily 2004). Executives of an SOE are banned from engaging in any critical step of restructuring, borrowing money from the company for a buy-out and raising a mortgage on its state-owned property for loaning from banks, according to the guideline. SOE executives who steal and misuse the state-owned property will be penalized seriously. It pledges to crack down on the intermediary organizations that provide fake audits, evaluations and pricing reports in SOE restructuring programmes.

1.2. Research Questions

The social issues and problems Chinese government and management of firm faced were how to restructure/privatize enterprises with a strong socially responsible sense to minimize large scale job losses, and mitigate negative impact on the stakeholders such as workers/employees, shareholders, community, etc.. The cases reported in Table 1-1 reveal that most of workers' protests were triggered by the socially irresponsible actions, e.g. when restructuring/privatizaion occurred, workers were totally excluded from the restructuring process, managerial power and decisions. Management made decisions on restructuring behind the scenes, deliberately keeping knowledge of decisions from workers until they were formally announced, not to mention open communications with those who are affected by restructuring. They seldom brings up issues arising from restructuring for open discussion in enterprises.

In this study, therefore, I will empirically explore the questions and phenomena: How do Chinese managers perceive and interprete CSR and socially responsible restructuring (SRR)? To what extent do the managers' attitudes affect their behaviors with regard to SRR, are the managers whose attitudes are more in faviour of CSR may engage in more socially responsible restructuring? Does socially responsible restructuring improve firm's financial performance or does financial performance drive socially responsible restructuring? Whether was firm's financial performance improved after restructuring, and what factors might influence the change in performance improvement?

In this study, there are several key concepts playing an important role for us to understand the relationship between CSR and firm's performance. The first concept is CSR, which means that a corporation should be held accountable for the consequences of their actions affecting the firm's stakeholders while they pursue economic goals, integrating social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis. The second is SRR that is defined as the restructuring a firm undertakes to balance and take into consideration of the interests and concerns of stakeholders who are affected by the changes and decisions, involve the affected stakeholders in the process of restructuring through open communication and consultation, adopt social support programme to assist those who are affected after restructuring. The third one is stakeholders that is defined as all the groups affected by, or that can affect, an organization's decisions, policies and operations. The last one is CSP which is defined as "a business organization's configuration of principles of social responsibility, processes of social responsiveness, and policies, programs, and observable outcomes as they relate to the firm's societal relationships" (Wood 1991a, p.693). With a performance perspective, it is clear that firms must formulate and implement social goals and programmes as well as integrate ethical sensitivity into all decision-making policies and actions. Based on the definitions, the study employs two basic approaches to assess company's social performance in restructuring: a focus on process and a focus on outcomes. The indicators for measuring socially responsible performance are developed in the survey instrument.

1.3. Organization of the Thesis

The thesis is organised in 9 chapters. Chapter 1 is the introduction; Chapter 2 presents theory and literature review, which covers corporate social responsibility; enterprise restructuring, corporate governance and socially responsible restructuring; Chapter 3 presents the overview of enterprise reform and restructuring and its social impact in the People's Republic of China during the 1990s. Chapter 4 develops the conceptual framework and hypotheses, and Chapter 5 presents data and methodology. Chapter 6 examines the relationship between managers' attitudes toward CSR and their socially responsible behaviour; Chapter 7 discusses the relationship between firm's financial performance and socially responsible performance in restructuring; Chapter 8 presents a case study of Chinese defence industry, and Chapter 9 are summary and conclusions.

In Chapter 2, the literature on CSR, enterprise restructuring, corporate governance and socially responsible restructuring is reviewed. The review of CSR focuses on what CSR is; how CSR emerges and develops in China; and how to examine corporate social performance, and its relationship with financial performance. The review of enterprise restructuring presents an overview of the empirical phenomena in the transitional economies, the relationship between enterprise restructuring and firm's performance. Literature on corporate governance in the developed economies of the west and in the transitional economies is reviewed to highlight the governance issues and problems encountered in transition in order to learn lessons for China. The issue of management empowerment and ownership control is discussed to assess its influence on socially responsible restructuring. The review of socially responsible restructuring focuses on the definition, the examination of factors that affect the extent of socially responsible performance in restructuring; the role of corporate governance system in shaping the patterns of restructuring, and how the different corporate governance models influence the degree of CSP.

Chapter 3 discusses the macro-economic background and policies of China's government, particularly, its impact on economic restructuring and enterprise reforms.

The important turning points of economic reform and policymaking since 1978 are reviewed to provide us with assessment of environment in which enterprises are restructuring and developing, and to identify the progress and constraints in restructuring and privatizing enterprises in China. This chapter also analyzes China's enterprise reform process and its impact on corporate governance, social security.

In chapter 4 and 5, the conceptual framework for this study is designed and the methodology of this research is presented. The research employs both quantitative and qualitative methods. The management survey was conducted to assess the perceptions of managers toward CSR, and a case study is comprehensively analyzed to give insight of phenomena of socially responsible restructuring. In addition, the relationship between socially responsible restructuring and financial performance was investigated by using the data of sampled 318 listed firms.

Chapter 6 presents the empirical study on how the managers perceive and interpret CSR in China, and especially, on whether socially responsible value-oriented managers tend to behaviour in restructuring activity in a more socially responsible manner.

Chapter 7 presents the empirical examination of relationship between socially responsible restructuring and financial performance. This Chapter also employs econometric estimation model to explore the sources of firm performance changes; focus is placed on examining the relationship between social responsible performance and firm's performance in pre-and post-restructuring.

Chapter 8 presents the empirical result of a case study of Chinese defence industry. The case study illustrates how a Chinese firm attempts to balance the economic and social priorities in enterprise restructuring, and to provide us with an insight into how socially responsible restructuring actions can lead to successful outcomes and not always entail job losses, and thus minimizing the negative aspects associated with restructuring.

Finally in Chapter 9, a synthesis of the results of the study is presented. The findings of the study are elaborated, implications of the study are assessed and some policy recommendations are derived from the findings.

Chapter 2 Theory and Literature

2.1. Introduction

In this Chapter, I will review and discuss the theory and literature which can provide theoretical framework for defining the concept of socially responsible restructuring, and the methodology for examining the relationship between socially responsible restructuring and firm's performance.

The literature review is organized around and related directly to the research questions. I will look at issues of theory, methodology in the fields of CSR, enterprise restructuring, corporate governance and socially responsible restructuring. The literature review is done by a guiding concept - stakeholder theory. The stakeholder theory is a core concept in this study, because gaining a better understanding of the firm's performance and social responsibility has been accounting for and managing the interests or "stakes" of key players inside and outside of the organization. Difference in and conflict among various stakeholders can have a dramatic effect on the ability of any organization to perform efficiently and in socially responsible way (Becker and Potter 2002).

The stakeholder theory is applied to evaluate corporate social performance in restructuring by analyzing corporation's relationships with its stakeholders. The concepts of CSR, and corporate governance and restructuring are also devloped and defined against stakeholder theory.

The Chapter is organized in four Sections, in addition to this introduction. Section 2.2 investigates what CSR is, and what issues and problems of CSR that China's firms face. The relationship between CSP and financial performance is examined in the previous researches. Section 2.3 defines the concept of restructuring, and takes an overview of the empirical phenomena in the transitional economies, and then examines how restructuring has been constructed as both positive development and antisocial behaviour in different social science literature. The relationship between enterprise restructuring and firm's performance is also explored. In Section 2.4, corporate governance was reviewed to draw out implications about the relationship between corporate governance and corporate restructuring. I present the different models of corporate governance, and its impact on the extent of socially responsible performance. The issues of corporate governance in transitional economies are also analyzed. Section 2.5 intends to examine what is socially responsible restructuring, what factors affect the extent of socially responsible performance in restructuring; what is the role of corporate governance system in shaping the patterns of restructuring.

2.2. Corporate Social Responsibility

Corporate social responsibility (CSR) has grown exponentially in the last decade. A larger number of companies have been increasingly engaged in a serious effort to define and integrate CSR into all aspects of their businesses. An increasing number of shareholders, analysts, regulators, activists, labour unions, employees, community organizations, and news media are asking companies to be accountable for an ever-changing set of CSR issues. Managers continually encounter demands from multiple stakeholder groups to devote resources to CSR. These pressures emerge from customers, employees, suppliers, communities, governments, and stockholders, especially institutional shareholders.

Freeman (1984) argues that firms have relationships with many constituent groups and that these stakeholders both affect and are affected by the actions of the firm. Stakeholder theory, which has emerged as the dominant paradigm in CSR, has evolved in several new and important ways. When business interacts so often and so closely with society, a shared interest and interdependence develops between a company and other social groups. When this occurs, corporate stakeholders are created. Stakeholders are all the groups affected by, or that can affect, an organization's decisions, policies, and operations. The concept of stakeholder personalizes social or societal responsibilities by delineating the specific groups or persons that business should consider in its CSR orientation. Management challenge is to decide which stakeholders merit and receive consideration in the decision-making process. A company's success can be affected negatively or positively by its stakeholders. In an era when business strategies are changing because of such forces as global competition, new political arrangements, shifting public values, and ecological concerns, managers are challenged to achieve good economic results while also considering the needs and requirements of their business's stakeholders (Post, Lawrence, and Weber 2001). Clarkson's long-term study of corporate behaviour (Clarkson 1995) indicates that companies deal with stakeholders, not society, and that CSR must distinguish between stakeholder needs and social issues; managers can address stakeholder requirements but not abstract social policy.

Carroll (1979) suggests CSR has different layers: economic, legal, ethical and discretionary categories of business performance and those business leaders must decide the layer at which they choose to operate. Carroll proposed a four-part definition of CSR that was embedded in a conceptual model of CSP. His basic argument was that for managers or firms to engage in CSP they needed to have (a) a basic definition of CSR, (b) an understanding/enumeration of the issues for which a social responsibility existed (or, in modern terms, stakeholders to whom the firm had a responsibility, relationship, or dependency), and (c) a specification of the philosophy of responsiveness to the issues (p. 499). I will restrict my discussion here to the basic CSR definition.

At the time of his proposal, Carroll noted that previous definitions had alluded to businesses' responsibility to make a profit, obey the law, and "go beyond" these activities. Also, he observed that to be complete, the definition had to embrace a full range of responsibilities of business to society. In addition, some clarification was needed regarding that component of CSR that extended beyond making a profit and obeying the law. Therefore, Carroll offered the following definition: "The social responsibility of business encompasses the economic, legal, ethical, and discretionary expectations that society has of organizations at a given point in time" (Carroll, 1979, p. 500).

Carroll argued that business has a responsibility that is economic in nature or kind: Before anything else, the business institution is the basic economic unit in our society. As such it has a responsibility to produce goods and services that society wants and to sell them at a profit. All other business roles are predicated on this fundamental assumption (Carroll, 1979, p. 500). The economic component of the definition suggests that society expects business to produce goods and services and sell them at a profit. This is how the capitalistic economic system is designed and functions. Just as society expects business to make a profit (as an incentive and reward) for its efficiency and effectiveness, society expects business to obey the law. The law represents the basic "rules of the game" by which business is expected to function. Society expects business to fulfil its economic mission within the framework of legal requirements set forth by the society's legal system. Thus, the legal responsibility is the second part of the definition (Carroll, 1979, p. 500).

The next two responsibilities represented Carroll's attempt to specify the kind or nature of the responsibilities that extend beyond obedience to the law. The ethical responsibility represents the kinds of behaviours and ethical norms that society expects business to follow. These extend to behaviours and practices that are beyond what is required by the law. Although they seem to be always expanding, they nevertheless exist as expectations "over and beyond legal requirements" (Carroll, 1979, p. 500). In later writings (Carroll 1981; Carroll 1991), Carroll elaborated on the ethical responsibility component, which he saw as growing in importance. Finally, there are discretionary responsibilities. These represent voluntary roles that business assumes but for which society does not provide as clear-cut an expectation as it does in the ethical responsibility. These are left to individual managers' and corporations' judgment and choice; however, the expectation that business perform these still exists. This expectation is driven by social norms. The specific activities are guided by businesses' desire to engage in social roles not mandated or required by law and not expected of businesses in an ethical sense, but which are increasingly strategic. Examples of these voluntary activities, during the time in which it was written, included making philanthropic contributions, conducting in-house programs for drug abusers, training the hard-core unemployed, or providing day-care centres for working mothers (Carroll, 1979, p. 500).

In 1983, Carroll further elaborated on his 1979 four-part definition of CSR: In his view, CSR involves the conduct of a business so that it is economically profitable, law abiding, ethical and socially supportive. To be socially responsible . . . then means that profitability and obedience to the law are foremost conditions to discussing the firm's ethics and the extent to which it supports the society in which it exists with contributions of money, time and talent. Thus, CSR is composed of four parts: economic, legal, ethical and voluntary or philanthropic (Carroll, 1983, p. 604). In his statement, Carroll reoriented the discretionary component as involving voluntarism and/or philanthropy, because this seemed to be the arena from which the best examples of discretionary activities came.

In 1991, Carroll revisited his four-part CSR definition (Carroll, 1991). By this time, Carroll was referring to the discretionary component as philanthropic and suggesting that it embraced "corporate citizenship." He stated that for CSR to be accepted by the conscientious business person, it should be framed in such a way that the entire range of business responsibilities is embraced. It is suggested here that four kinds of social responsibilities constitute total CSR: economic, legal, ethical and philanthropic. Furthermore, these four categories or components of CSR might be depicted as a pyramid. To be sure, all of these kinds of responsibilities have always existed to some extent, but it has only been in recent years that ethical and philanthropic functions have taken a significant place. (p. 40)

The pyramid of CSR depicted the economic category as the base (the foundation upon which all others rest), and then built upward through legal, ethical, and philanthropic categories (Carroll, 1991, p. 42). Carroll made it clear that business should not fulfil these in sequential fashion but that each is to be fulfilled at all times. It also should be observed that the pyramid was more of a graphical depiction of CSR than an attempt to add new meaning to the four-part definition. Stated in more pragmatic and managerial terms, Carroll summarized, "The CSR firm should strive to make a profit, obey the law, be ethical, and be a good corporate citizen" (p. 43). In this same article, Carroll provided segue from CSR to stakeholder theory/management by observing, "There is a natural fit between the idea of corporate social responsibility and an organization's stakeholders" (p. 43). He argues that the term "social" in CSR has been seen by some as vague and lacking in specificity as to whom the corporation is responsible, Carroll suggested that the stakeholder concept, popularized by Freeman (1984), personalizes social or societal responsibilities by delineating the specific groups or persons business should consider in its CSR orientation and activities. Thus, the stakeholder nomenclature puts "names and faces" on the societal members or groups who are most important to business and to whom it must be responsive.

2.2.1. Concept and Definition

In academic debates and business environments, hundreds of concepts and definitions have been proposed referring to a more humane, more ethical, more transparent way of doing business.

Marrewijk (2003) provides an overview of the contemporary debate on the concepts and definitions of CSR and corporate sustainability (CS). The conclusions he made, based on historical perspectives, philosophical analyses, impact of changing contexts and situations and practical considerations, show that "one solution fits all"-definition for CS(R) should be abandoned, accepting various and more specific definitions matching the development, awareness and ambition levels of organizations.

In academic literature, various authors have referred to a sequence of three approaches, each including and transcending one other, showing past responses to the question to which an organization has a responsibility. According to the shareholder approach which is regarded by Quazi and O'Brien (2000) as the classical view on CSR, "the social responsibility of business is to increase its profits" (Friedman 1962). The shareholder, in pursuit of profit maximization, is the focal point of the company and socially responsible activities don't belong to the domain of organizations but are a major task of governments. This approach can also be interpreted as business enterprises being concerned with CSR "only to the extent that it contributes to the aim of business, which is the creation of long-term value for the owners of the business" (Foley 2000).

The stakeholder approach indicates that organization is not only accountable to its shareholders but should also balance a multiplicity of stakeholders' interests that can affect or are affected by the achievement of an organization's objectives (Freeman 1984). According to the societal approach, regarded as the broader view on CSR (and not necessarily the contemporary view), companies are responsible to society as a whole, of which they are an integral part. They operate by public consent (licence to operate) in order to "serve constructively the needs of society - to the satisfaction of society".

The philanthropic approaches might be the roots of CSR, but the different approaches to corporate responsibility clearly show that CSR is a new and distinct phenomenon. Its societal approach especially appears to be a (strategic) response to changing circumstances and new corporate challenges that had not previously occurred. It requires organizations to fundamentally rethink their position and act in terms of the complex societal context of which they are a part. This is a new perspective.

In summary, CSR means that a corporation should be held accountable for the consequences of their actions affecting the firm's stakeholders while they pursue traditional economic goals, integrating social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis.

2.2.2. Perceptions of Managers toward CSR

Many studies argue that the attitudes and intentions of top management are central to the strategy process of a firm. Katz (1960) claims that attitudes provide people with a framework within which to interpret the world and integrate new experiences. Ajzen and Fishbein (1977) further suggested that by understanding an individual's attitudes toward something, one can predict that individual's "overall pattern of responses" to the object. They argued that a single behaviour is determined by the intention to perform the behaviour in question. A person's intention is in turn a function of his attitude towards performing the behaviour. Not only will, therefore, managerial values frame the issues evaluation process but they are also likely to directly shape the issue management process as well.

Wood (1991a) underscores individual or managerial intentions as the motivators of socially responsible behaviour, the management of stakeholder expectations as an integral part of the process, and an emphasis on programmes and policies as the primary outcomes of those processes, an assessment of a manager's attitudes toward to corporate social responsibility (CSR), then, may provide an indication of the manager's predisposition to respond in a particular way to CSR. One striking case could illustrate their arguments. It is reported in Europe, the French-based food group Danone has long had an image as a "socially responsible company". Antoine Riboud, who was head of the company until 1996, cultivated a reputation as a "socially-oriented boss". He and his successors always live up to the socially responsible-oriented value, although since late 1990s, Danòne Group has undergone restructurings in different sectors, have been undertaken in a more socially responsible manner, and become the model of socially responsible restructuring in Europe.

Keith Davis's landmark article laid the foundation and benchmark for the researchers to assess attitudes of managers toward CSR (Davis 1973). He stressed some of the important arguments relating to the case for and against the business assumption of social responsibility. Later, most of researchers (Rashid and Ibrahim 2002; Quazi and O'Brien 2000; Ostlund 1977; Orpen 1987; Ford and McLaughlin 1984) incorporated many of the same arguments in their studies, aimed at measuring managerial attitudes toward social responsibility. Although the statements used in their studies modified in terms of language, style and direction to suit their research purposes, the format used in their studies is similar to each other.

Some of the studies attempted to examine the attitudes of different groups in one country. Ostlund (1977), Ford and McLaughlin (1984) surveyed two different groups in US and examined different attitudes. Ostlund (1977) conducted survey of Fortune 500 executives to compare the attitudes toward social responsibility expressed by corporate policy makers with those of a group of operating level managers. The study centred on six areas of greatest concern among top executives, which included the arguments for and against corporate CSR involvement; the CSR priority; the extent of difficulty which managers see their corporations experiencing these same CSR areas; the extent of manager involvement in policy formulation and implementation within each CSR area; the difference between top management and operating management attitudes toward specific aspects of CSR areas, and finally, the implementation difficulties. The results of his research showed that operating managers were at least as inclined as top managers to agree with statements in support of CSR. Moreover, their degree of non-acceptance of commonly recited obstacles or barriers to CSR policy implementation was found to be no different from that of top managers. Ford (1984) compared the perceptions of corporate executives and business school deans about CSR to determine whether or not business leaders and business educators are in agreement as to what practices are evidence of socially responsible behaviour, how intensely these activities are being supported by business leaders, and what arguments for and against the acceptance of corporate social responsibility have merit. Ford's study claims that both dean and CEOs recognizes very similar priorities for socially responsible activities, with the CEOs having the more sanguine viewpoint. In addition, there appears to be more sceptical perspective among the dean than the CEOs in their statements about the basis of support for social responsibility.

Orphen (1987) and Quazi (2000) used the same approach to study the two groups in different countries and investigated the cross-national model of CSR. Orpen

(1987) assessed the attitudes of 164 US and 151 South African managers toward corporate social responsibility. It was found that the US managers held much more favourable attitudes toward corporate social responsibility. Also, the US managers agreed with more pro-responsibility arguments, whereas the South African managers agreed with more anti-responsibility arguments. The US managers felt that their society expected more corporate involvement in social responsibility activities than the South African managers believed was expected from their society. The results were explained in terms of the susceptibility of social responsibility attitudes to cultural norms and values, which show the different nature of the two societies. Quazi (2000) attempted to develop a two-dimensional model of corporate social responsibility and empirically test its validity in the context of two dissimilar cultures-Australia and Bangladesh. It was concluded that corporate social responsibility is two-dimensional and universal in nature and that differing cultural and market settings in which managers operate may have little impact on the ethical perceptions of corporate managers.

Some of the researchers investigated the change in the attitudes of the executives over time. For example, Holmes (1976) examined the executive perceptions of CSR in the USA and how their opinions and the philosophies of their firms concerning social responsibility have changed over the past five-year period (1970-1975), and what future changes they anticipate. The results showed that a significant change in executive opinions and corporate philosophies of social responsibility has occurred over the past five-year period. Executive anticipated more positive than negative outcomes from the social efforts of their firms, and almost all executives believed that corporate reputation and goodwill would be enhanced through social endeavours. Factors relating to the special competencies of the corporate and the seriousness of a social need were believed to be the most influential in the selection of areas for corporate social involvement. The majority of executives was optimistic about the ability of business to alleviate social problems and believed that the level of corporate social efforts was only partially determined by general economic conditions. Rashid and Ibrahim (2002) examined the attitudes of Malaysian managers and executives toward social responsibility and also the extent of socially responsible activities involved, corporate disclosure, and the factors determining the attitudes towards social responsibility over the past ten years (1991-2001). The findings of the study indicate that although the Malaysian executives and managers had positive attitudes toward CSR, the extent of their involvement in CSR was lower in year 2002 than a decade ago. The extent of corporate disclosure on CSR was nevertheless slightly higher in 2001 than in 1991. It implies that while CSR is not a recent phenomenon in Malaysia, the level of awareness appears to have improved slightly.

Lerner and Fryxell (1994) study the issue from the different perspective. They employed Wood's corporate social performance model (1991) to investigate CEO stakeholder attitudes and corporate social activities. In this study, various corporate social activities were regressed on self-report measures of stakeholder-orientations from 220 CEOs from large Fortune500 industrial and service firms. The results demonstrated that at least, with regard to discretionary activities, such as charitable activity, the preference of the CEO may have a direct, albeit modest, influence. The relationship between CEO attitudes toward certain stakeholder groups (e.g. stockholder, employees, customers, managers, government, and community) and actual corporate activities geared toward those groups are unclear. CEO intentions or preference are constrained by a combination of external conditions and internal inertia or simply diluted in their passage down the organization. This study empirically reveals that CEOs do attribute varying degrees of importance to different stakeholder groups, and to some degree, these prioritizations actually translate into corporate actions.

Some researchers turned the attention to developing countries in this area. Teoh and Thong (1984) focused their research on attitudes of management in developing countries. They believed that the philosophy of top management and legislation are primary factors contributing to corporate social awareness. Nearly 50 percent of respondents considered the view that the social responsibility of business is reflected in the active concern for the social impact of the economic activities of business. This study examined the variations in social involvement by the type of business activity, and found some differences.

Gill and Leinbach (1983) conducted a survey in Hong Kong to identify what attitudes concerning social responsibility prevail in Hong Kong corporations. After examining the attitudes of senior and middle managers toward consumerism, shareholders, employees, society, customers, the survey found that there appeared to be little room for the practice of social responsibility. Although there were some positive attitudes toward CSR, there were also negative attitudes toward it. For instance, whereas 81 percent of respondents agreed on the statement that firms should be concerned about the environmental and social consequences of their business activities even to the extent of sacrificing short-term profitability, only 35 percent agreed that a company should subscribe to charities for humanitarian reasons rather than for public relations of self-interest. In examining the determinants of the managers' attitudes toward CSR, the study found that family training and upbringing, and traditional beliefs and customers are primary factors. Rashid and Abdullah (1991) judged that family upbringing was rated as the most important factor, followed by religious training. The conduct of superiors was ranked third, followed by traditional beliefs and customers.

2.2.3. CSR in China: Issues and Problems

In China, CSR or corporate citizenship has been introduced to practitioners and academic researchers only in recent years. The introduction is driven by both external and internal factors. Externally, over the past few years, particularly after China's entry into WTO, more multinational corporations have expanded their businesses in China, with the rise in trade, the requirements for good quality of products and services are increased, and hence the attention of trading with China has caused the tension between business practice based on profit-making and anti-capitalist campaign promoting operation standards, best business practices, western values and moral standards. Internally, more Chinese corporate activities have expanded into the global market; it is imperative that managers adopt different business culture. Such cultural expectations from host countries include CSR behaviour of their firms, dealing with different culture-based corporate conduct for managers in international business. It is important for these enterprises to better understand and anticipate the expectations different host countries may have for CSR in the context of international business. These companies may serve as agents of change promoting ethical and responsible business behaviour in China.

CSR has been of major concerns in China's society in recent years. Since economic reform, role of the Chinese businesses in the new division of social responsibilities has been changing, but often changing in the opposite direction to that prescribed by advocates of increased CSR. The goal of economic freedom and individual wealth has grown rapidly in China and has replaced the former Confucian and Maoist values. More and more attention is paid to economic gain, while balancing profits and moral standards is becoming less important. These changes have led to and influenced CSR and definition of key stakeholders. More and more Chinese business people are generally more motivated by profit and view profitability as the primary overriding goal. Professional morality has weakened, social responsibility has dimmed and the phenomenon of money-worship has grown. Problems have grown with over-stressing material interests, putting profit before everything and over-emphasizing competition by fair means or foul and engaging in local protectionism. Under increasing pressure from market competition, enterprises may pay too much attention to economic gains and leave loopholes in balancing profits and moral standards.

Chinese SOEs are increasingly liberated from welfare provisions and allowed to get down profiting maximization. Some of the most economically dynamic sectors of the economy, such as the nominally "collective" rural industries have driven in an almost complete unregulated environment. Many of these frontier industries have been highly polluting and have offered low wages and minimal health and safety standards to non-unionized rural migrants, of whom there is nonetheless a steady supply. Such industries have been highly profitable (Young and MacRae 2002). The paradoxical phenomenon is that the more profits people are making, the less social responsibility they are assuming. The integrity and ethics of managers have been questioned, and it leads the heated debate with regard to whether the corporate responsibility to society should be one of the most important standards to assess firm's performance.

The issues and problems of CSR that Chinese firms are facing reflect in the corporate governance arrangements as well which are required to be established in firms during the transformation of SOEs into the modern enterprise system.

China is establishing its corporate governance structures by emulating the stylized Anglo-American model. However, the country does not yet have the necessary formal and informal institutions or the financial infrastructure to make these structures work effectively. Corruption, stock market manipulation, tax cheating, fraudulent dealing, all manners of plundering of state assets and the lack of protection of shareholders' rights are some of the more conspicuous manifestations of the ethical issues that have emerged in this mismatch.

In many ways, nowhere are such new ethical issues brought into sharper focus than in the development of corporate governance in China's listed companies, the supposedly most modern and market-oriented business organizations in China. Tam (2002) examines the key corporate governance and ethical issues associated with this type of companies. As a result of the more rapid pace of corporatization and *de facto* privatization of state owned enterprises since the early 1990s, corporate governance has assumed an increasing prominence in China's reform agenda as the Chinese government tried to promote enterprise performance and to look after its ownership stakes in various forms. The widespread and persistent financial distress experienced by many SOEs has added to the urgency of getting the country's corporate governance right.

Tam's study (2000) reveals that the business ethical issues associated with China's corporate governance arrangements are the product of several interacting factors. They stem firstly from the struggle between the desire to install "modern" institutions and instruments, and the unbalanced progress in the development of complementary social, political, legal and economic infrastructures. Another equally important factor can be attributed to the approach taken by the Chinese government to establish a corporate governance system based on the stylized Anglo-American model.

Tam identifies and explains the emerging ethical issues in the context of the China's evolving macro environment as well as its corporate governance arrangements. He argued that in China's listed firms, the opportunistic and strategic behaviour by firms' directors and managers to advance their interests at the expense of the company's shareholders and other stakeholders has been a major governance and ethical issue. Such behaviour has even taken the form of illegal activities such as looting of company assets and various forms of corruption within and outside the company.

Protection of shareholders rights

The current ownership structure of China's listed companies, the constraints and interventions exerted by the state on them, and the inability of the government to effectively exercise its rights as the majority shareholder combine to produce a multitude of governance and ethical issues for policy makers, investors as well as company board chairman and chief executives. First, the state is the majority shareholder but is not exercising its ownership rights effectively. Instead the insider managers and their Party-ministerial associates who personally have negligible shareholding hold the control of the company. Thus, in reality the governance and the purpose of the firm are determined by the insiders, often involving government agencies other than the designated holder of the state shares.

In the Czech and Russian privatization process, the insiders rapidly gained concentrated ownership. This has not happened in China. However, the corporate regulatory regime in China is in principle geared to accommodate diverse share ownership as the Anglo-American model is the object of emulation. Unfortunately, it has been shown that the primary purpose for Chinese state enterprises going public is to raise capital, not to transfer ownership from state to private citizens[7]. Indeed raising capital from the capital market can mean survival for many of the SOEs that have been partially privatized in this manner.

From an analytical perspective, the board of directors can be interpreted as a security feature in support of the contract for equity finance, but China's partially privatized listed companies are in a peculiar position as the individual minority shareholders that actually provide much of the equity finance are quite powerless in the entire governance scheme. As the state shareholders cannot manage their equity investment because their shares are not tradable on the market, and because state budgetary constraint means they will have little access to fiscal resources to participate in capital augmentation such as rights issues, their ownership stake is highly constricted.

The result is that, even if there were no self-serving strategic behaviour on the part of directors and managers, there will be the difficult issue of resolving the different interests and pursuits of the central and sub-national levels of government in setting the goal and direction of a company's business and governance aspirations. Examples of such conflicting interests may include employment creation and maintenance, welfare for workers, social stability, and government revenue collection. The actual reality in China where the rights of the numerous individual minority shareholders are often disregarded does not help in providing directors and executives a basis for the resolution of this issue. A conclusion that can be drawn from the above discussion is that given the

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[7] Su, Dongwei, 2000, Leverage, Insider Ownership, and the Underpricing of IPOs in China. Department of Economics, University of Akron, Ohio.

circumstances in China, the protection of minority shareholders' interest is ironically a precondition for the state to better manage its own majority shareholder interest.

Insider trading, self dealing and collusion in market manipulation

It was after the Securities Law came into effect in July 1999 that the Chinese authorities (notably the China Securities Regulatory Commission [CSRC]) began a more active campaign to investigate cases of insider trading and market manipulation. Although details are not always readily available, such activities seem rampant and persistent as evidenced by the revelations made in recent prosecutions and by the popularity of books on how individuals can take advantage of such activities. The common practice seems to involve a company, either acting on its own or in collusion with others. Borrowed or own funds are channelled through a large number of factitious or personal investor accounts to engage in buying and selling of its own shares (i.e., self dealing) or other companies' shares to influence market prices and trading volume to attain personal financial gains. Clearly such activities would have been detected quite easily should there be effective corporate governance arrangements and regulatory surveillance and enforcement mechanisms.

Market manipulation activities of this nature would be difficult to succeed without the consent or cooperation of securities investment firms or brokerage companies. China's fledging securities industry is certainly under-developed and has on many occasions not been able to deliver the supporting governance role expected of them.

More significant is the fact that some of the securities firms actually engaged on their own in similar kind of activities on an even grander scale. The recently reported case of the alleged market manipulation and corruption by a provincial branch head of a major securities and brokerage firm is indicative of the problem." The manager in question was alleged to have opened 900 factitious investor accounts in the name of her associate to apply for new scribes from Initial Public Offerings (IPO), using company funds and unauthorized mortgage credits. Since most IPO in China are under-priced, 38 successes in getting scribes is therefore almost a certain way of making quick profits. This may indeed be an important factor that has contributed to the tendency of some companies to falsify financial statements to gain new listing or to expand share issues.

Falsification and fabrication of financial data

Under China's current conditions, obtaining a public listing for many companies is a cheap way of finance that will also bestow enormous legitimate and illegitimate benefits to a company's managers and employees. Because the listing procedures are based on a national quota system, regional and sectional interests may dominate commercial considerations in the selection of companies. The standards and integrity of professionals such as accounting, legal and securities firms are seriously compromised when falsification of a company's financial performance occurs. China's formal and informal institutions needed to support its corporate governance system are still at a very early stage of development. Because of the asymmetrical nature of these institutions to the needed development of some of the prerequisites of the Anglo-American corporate governance model, issues such as the above are bound to inflict damages.

In conclusion it is clear that specific ethical issues such as protection of shareholders and other stakeholders rights, corruption, plundering of state and company assets, and fraudulent dealings are the product of weaknesses in China's corporate governance structures as well the asymmetrical development in formal and informal institutions under which all companies have to operate. China has patterned its formal corporate governance structures on the Anglo-American model but lacks the required institutional and market conditions. These institutions will take some time to develop to suit the country's particular economic, financial and political circumstances. Ethical issues that have arisen in the process of the country's reform and development are path dependent and intertwined with the formal and informal aspects of the economy, society and polity.

2.2.4. Corporate Social Performance and Firm's Performance

2.2.4.1. What is Corporate Social Performance?

The evolution of corporate social performance (CSP) research is marked by several distinct generations of work. Initially, there was an energetic push to develop and define CSR construct as a rebuttal to the notion that a corporation owed a duty only to its stockholders. That is, firms owe a duty to society stretching beyond shareholders

(Jones 1980). Next did the operationalization of this definition (CSP) come, which researchers used to test the social responsibility notion by outlining the various duties or constituency groups that corporations must honour?

CSP can be defined as a business organization's configuration of principles of social responsibility, processes of social responsiveness, and policies, programs, and observable outcomes as they relate to the firm's societal relationships (Wood 1991a). Building on this definition, Wood and Jone (1995) propose that stakeholder theory is the key to understanding the structure and dimensions of the firm's societal relationships. They redefine the policies, programs, and outcomes as "internal stakeholder effects, external stakeholder effects, and external institutional effects" and argue that stakeholders set norms for corporate behaviour, experience the effects of corporate behaviour, and evaluate corporate behaviour.

2.2.4.2. Measurement of CSP

Single Dimension as Proxies for CSP

Wood (1991) develops a hierarchy of interpenetrating dimensions: principles, processes, and outcomes. Clarkson (1995) categorizes CSP dimensions according to different stakeholder groups surrounding the focal organization. In addition, other schemes include dimensions corresponding to particular issues. For example, Post and Baer (1980) examine the issues involved with the use of infant formula in less developed countries. In addition, the Kinder, Lydenberg, and Domini (KLD) database, an extensively utilized measure of CSP, includes "exclusionary screens" (Domini Social Investments 1997), which identify social issues from which firms should not gain economic rents, such as alcohol, gambling, smoking, weapons manufacturing, and nuclear power generation.

Although CSP is a multidimensional construct, many researchers rely on a single dimension in their operationalization. Generalizations about the CSP-financial performance (FP) link have been made from studies that operationalize CSP using air pollution (Chen and Metcalf 1980; Freeman and Jaggi 1994; Shane and Spicer 1983), illegal activity (Davidson and Worrell 1988; Baucus 1989) and product recall (Hoffer, Pruitt, and Reilly 1988; Bromiley and Marcus 1989). Two criticisms are commonly directed at the practice of performing single dimension studies. First, these studies do not capture firms' social performance as they "inadequately reflect the breadth of the construct" (Griffin and Mahon 1997) and thus lack an appropriate level of validity. A clean record on air pollution does not uncover other aspects of CSP, such as illegal activity (antitrust, insider-trading), employee relationship issues (sweatshop labour in less developed countries), or products deemed socially undesirable (weapons or nuclear power). For example, through the stakeholder lens, CSP is a measure of a firm's behaviour toward several constituent groups (see Jones, 1980). As such, attention to anyone stakeholder group, or issue for that matter, neglects other groups/dimensions and cannot independently serve as a proxy for CSP.

Second, in addition to validity problems, the reliability of this approach is suspect. Generalizations from these studies and comparisons to other CSP studies have little credibility and provide few insights. In the set of studies they examine, (Reed et al 1990) find that social performance is measured in at least 14 different ways. How do we compare empirical CSP studies employing firms' toxic release profiles to those exclusively focusing on illegal activity? There is no reason to assume that these studies will lead to consistent findings or that comparisons would have any meaning. Moreover, this comparison problem is exacerbated because many CSP-FP studies involve multiple industries (Griffin & Mahon, 1997), which are characterized by distinct issues and stakeholders. These industry-level factors make comparisons across studies meaningless as there is no way to control for heterogeneity related to the dependent variable. That is, we cannot assume that the appropriate dimensions of CSP in a given organizational field (or industry) are also relevant and form a comprehensive set for another operational setting. Thus, single dimension research designs lack the validity and reliability necessary for generalizing study findings beyond the research setting. As a result, this design significantly limits our ability to build understanding of CSP phenomena.

Aggregating Multiple Dimensions

Another common research design has been to aggregate several CSP dimensions into a composite measure. However, there are a number of issues related to composite measures. For example, by aggregating multiple dimensions into a composite measure, much of the meaning and richness in the data might be lost, and comparison across firms (and studies) might be more difficult; there is also a question of whether all the dimensions comprising the measure should receive the same weight. Moreover, multiple dimensional studies do not necessarily rely on the same set of dimensions, which raises two issues: What are the appropriate dimensions required to build a comprehensive CSP measure? How can we make comparisons across studies without a common measure?

Griffin and Mahon (1997) offer a solution that addresses the problems inherent in each of these multiple dimension measures. They build an aggregate measure based on a firm's average rank across multiple measures: Fortune Reputation Survey, Toxic Release Index, Corporate Philanthropy Index, and Domini Social Index. "The combination of both perceptual and numerical information (KLD) allows us to triangulate toward a representative measure of a firm's corporate social performance while mitigating the limitations and impacts of any single one of the measures". However, there is no reason to assume that the combination of these independent (but perhaps overlapping) measures will actually address the problems in each one. The dimensions that overlap across these measures, such as the pollution prevention category in the KLD data and emission levels in the Toxic Release Index, gain more importance (weight), whereas other categories gain less power in determining a firm's CSP. The relative weights assigned to each dimension are a by-product of this particular operationalization rather than a theoretical rationale that argues why this approach better captures the latent construct.

In addition, Rowley and Berman (2000) argue that the stream of work that aggregates multiple CSP dimensions utilizes an inappropriate research design. More specifically, in many cases, the choice of analytical model is mis-specified given the nature of the data and dimensions combined to represent CSP. For example, consider the components of the commonly used KLD measure: community (charitable giving, and support for housing, education, and other social initiatives), diversity (female and minority promotion, special interest group policies), employee relations (union relations, retirement benefits and employee profit sharing, and empowerment), environment (product attributes, pollution prevention, and recycling), and so on. Researchers employing this and other multidimensional operationalization have not provided a theoretical rationale suggesting these dimensions are correlated. Moreover, we suggest that there is no general theoretical reason to assume that charitable giving, employee profit sharing, and pollution prevention are significantly correlated. Also, there is empirical evidence that the KLD dimensions are not strongly correlated (Berman, Wicks, Kotha, & Jones, 1999; Johnson & Greening, 1999). Thus, the aggregation of dimensions does not represent a coherent latent (unobservable) variable.

As such, what can be expected from studies that perform correlation or OLS regression analyses of the relationships between CSP and other factors, such as financial performance? What would a significant finding indicate? Given the weak correlation structure among CSP dimensions, a positive and significant CSP-financial performance relationship would mean that some subset of the aggregated dimensions of CSP are related to financial performance, but the overall relationship has no meaning. Because the CSP measure is not internally correlated, suggesting that certain empirical findings show an association between CSP and financial performance is inaccurate and misleading. In addition, the explained variance is likely to be small because the unrelated CSP dimensions would contribute to the model's error term. Thus, this research design is mis-specified as it introduces unnecessary noise into the model and leads to incomprehensible findings. The problem is not a matter of degree. These approaches are not simply suboptimal but, rather, are wrong given that they produce results that cannot be interpreted.

Alternative research designs and analytical models are required. Structural equation modelling is more appropriate because researchers can simultaneously examine the measurement model-the relationship between each (latent) CSP dimension and each item used to capture it- and a structural model-the relationships among each latent variable including the dependent variable (e.g., financial performance).

One of the reasons that we lack a theoretical justification for a universal CSP measure relates to the underlying problem that pervades CSP research. Ullmann (1985) argues that CSP research is no more than "data in search of theory." Mitnick (1993) specifies these theory development problems, arguing that attempts to build theory in the field have neither failed to employ a sorting logic to justify the models nor considered the comprehensiveness of the phenomenon. As a result, the models "are little more than heuristics or graphical displays of lists; they are not conceptually operational" (p. 4). Mitnick's comments describe the field's attempt to define and operationalize the CSP construct: That is, the aggregation of multiple categories representing pieces of

CSP is no more than a list, which is not supported by an underlying understanding of CSP or a rationale for including the various categories as appropriate and comprehensive. Thus, Ullman's (1985) criticism stems from the observation that CSP lacks a "good sorting logic" that brings meaning to these lists of categories (Mitnick, 1995).

Thus, CSP-financial performance research lacks the appropriate level of theory to suggest why and how these constructs are related. Oftentimes, law-like statements identify the researchers' belief or opinion with regard to the CSP-financial performance relationship. However, law-like statements with regard to the connections between a set of variables do not constitute theoretical contributions in the realm of social science because there is little understanding generated from these claims in terms of explaining why (how) these relationships occur (Mitnick 1995)

Rowley and Berman (2000) adopt Wood and Jones' modification of Wood's definition of CSP. To operationalize this definition, they use outcome measures on five relationships that firms have with stakeholders. While their CSP measure is not comprehensive of all stakeholders, it is consistent with Wood and Jones's internal and external stakeholders. The outcome measures reflect firm relations with employees, consumers, environment, community, and society as whole.

Therefore, to assess a company's CSP, the researchers would examine the degree to which principles of social reasonability motivate actions taken on behalf of the company, the degree to which the firm makes use of socially responsive processes, the existence and nature of policies and programs designed to manage the firm's societal relationships, and the social impacts of the firm's actions, programs, and policies.

Many researchers have attempted to measure CSP employing various ways such as forced-choice surveys (Aupperle 1991; Aupperle, Carroll, and Hatfield 1985a), the Fortune reputation index and social responsibility index (McGuire, Sundgren, and Schneeweis 1988), content analysis of firm's reports and documents (Wolfe 1991), behavioural and perceptual measures (Wokutch and McKinney 1991), and case study (Clarkson 1991), however, it's difficult to measure it consistently because of the limitations. Now, researchers use social data from Kinder, Lydenberg, Domini (KLD) & Co. to assess CSP, for example, since 1996, business Ethics has ranked the 100 Best

Corporate Citizenship using KLD data. It looks at the strength and concerns in the areas of environment, community relations, employees relations, and diversity and customer relations.

2.3. Enterprise Restructuring

Since early 1990s, the extensive and aggressive political and economic reforms began to implement in Central and Eastern European transition economies. Enterprise restructuring or privatization has been widely used in these transition economies to remedy some problems of state-owned enterprises and to achieve a higher level of performance or to survive when the given structure becomes dysfunctional. Restructuring takes place at different levels. At the level of the whole economy, it is a long-term response to market trends, technological change, and macroeconomic policies. At the sector level, restructuring causes change in the production structure and new arrangements across enterprises. At the enterprise level, firms restructure through new business strategies and internal reorganization in order to adapt to new market requirements.

In recent years, a substantial theoretical literature has emerged on the process of economic restructuring in transition economies. As described by Blanchard, *et al* (1995); Black, *et al* (2000), there are two extreme views of transition. The first is that the main force behind the reform process involves the collapse of the state sector, which is not adapting to the changed market environment, combined with a slowly emerging private sector. The growth in the private sector is not sufficient to pick up the slack in the state sector, leading to high and persistent unemployment. Hence, unemployment slows down the desired restructuring of the state sector and other general reforms. It is for this reason that the optimal sequencing of reforms matters. While Aghion and Blanchard (1994b) stress the role of unemployment in "blocking" reforms, Roland (1994) stresses the role of political constraints that necessitate a gradual approach to restructuring. The second extreme view is that the main force behind transition is the rapid growth of the private sector, which is sufficient to absorb the laid off workers in the state sector. In this case, unemployment is a consequence of a healthy process of reallocation. This does not exclude the possibility of a high unemployment pool; what matters is a high turnover of that pool resulting in efficient reallocation.

2.3.1. Conception and Definition

Restructuring is a set of non-marginal changes in the structure of an existing firm's output mix, including the closure of some activities, which in turn requires significant non-marginal changes in resource use (Commander, *et al* 1999). In market-oriented economies, such restructuring is usually motivated by an attempt to restore or regain competitiveness and enhance long-term shareholder value in response to a radical change in the business environment or to a gradual erosion of competitiveness. To promote the transition from command to market economies, restructuring requires profit orientation as the overriding objective of the enterprise. By definition, restructuring is a process of radical adjustment that will break some vested interests. Restructuring encompasses both *survival-driven* cost-side changes aimed at reducing existing inefficiencies and *growth-oriented* revenue-side changes to re-orient the enterprise's processes and products to current market requirements and thereby achieve improvements in performance over the longer run (Carlin 1998). Survival-driven restructuring, which may involve labour shedding, plant closures and the search for new markets for existing products, is commonly a necessary first step to deeper restructuring. However, those survival-driven restructuring decisions that are motivated by a desire to make the minimum defensive changes necessary to avoid either more radical changes in output mix or exit will generally not be sufficient or even desirable. Such decisions will tend to tie up resources that could be more productively employed elsewhere. Growth-oriented restructuring, in contrast, generally involves substantial new investment in fixed and human capital as well as strategic changes in product mix. To be effective in a market economy context, such deeper restructuring generally requires the appropriate human capital expertise to identify profitable opportunities and sufficient financial resources to implement the associated investments.

Those growth-oriented restructuring decisions that lead to the highest feasible value of the enterprise (net of the cost of required resources) raise the level and rate of growth of enterprise-level productivity through both static efficiency effects and dynamic innovation. Even more important from an economy-wide perspective, the restructured firms will have a new mix of resources that better meets the requirements of downstream firms and final consumers. Resources which may have been subsidizing inefficient production can in turn be released and re-allocated to growing new and restructured enterprises, allowing over time better economy-wide resource allocation, higher employment, income and consumption levels.

Ericson (1998) argues that conceptually, restructuring of an enterprise must involve some substantial change in the organization, activities and relationships in which the enterprise is involved. However, to be analytically useful, the concept of restructuring must also involve a specific conscious orientation and motivation towards success in a future market environment, as well as significant change in operations and interactions. Aghion, Blanchard, and Carlin (1997) define restructuring as the changes that state-owned enterprise has to undergo in order to emerge as equivalent to a private sector firm. It typically entails changes in internal organization such as the separation of core from non-core activities, the closure of unviable units and spin-off of social assets; labour shedding and the reform of the incentive structure for employees and managers; and the modernization of equipment. A characteristic feature is that costly in short-run but offers the prospect of gains in the future.

Grosfeld and Roland (1997) introduce the distinction between two types of restructuring: defensive and strategic restructuring. The "defensive" part of restructuring means basically taking measures aiming to reduce costs and scale down enterprise activity: cutting the obsolete production lines, shedding labour, getting rid of non-productive assets, etc. The "strategic" part of restructuring is based on a thoughtful business strategy responding to the necessity of a profound redeployment of assets. It implies the introduction of new product lines and new processes, new technologies and new investments. It necessitates a great deal of entrepreneurial skills and imagination, a good judgement about investment opportunities and adequate incentives. It also requires sources of finance for the new projects. New investments can be financed from the firm's retained earnings, or via financial markets through bank credit and/or issuing of equity and debt on the market.

Obviously, restructuring can encompass a broad range of transactions, including selling lines of business or making significant acquisitions, changing capital structure through infusion of high levels of debt, and changing the internal organization of the firm. In this study, I define restructuring as the activity, which involves the deliberate modification of formal relationships among organizational components, such as redesigning work process, delaying, eliminating structural elements through outsourcing, spinning off, selling off, and divesting units, activities or jobs.

2.3.2. The Theory and Practice of Enterprise Reform

The theoretical work on enterprise-sector reform in transition economies has typically focused on how policy can be set so that good managers of state-owned enterprises (SOEs) are induced to exert effort to restructure and subsequently are able to expand the activities of the enterprise. Growth depends, as well, on fostering the entry of new firms. The other side of the coin is that poor managers must be denied access to new resources for expansion and lose the ability to hang onto other valuable resources in the enterprise.

Carlin and Landesmann (1997) draws on microeconomic, industry-level, and macroeconomic evidence to investigate the mechanisms of enterprise restructuring in transition economies, its outcomes in terms of industry-level export performance, and its interaction with macroeconomic policy and constraints. His study takes stock of what has happened in the enterprise sector in the leading transition economies and examine how that matches up with the orientation and findings of the theoretical analysis of transition. He investigates the extent to which the theoretical analysis of the determinants of enterprise restructuring has been reflected in practice at the micro level. A wide variety of evidence form both leading transition economies and Russia is brought to bear on the issue of the efficiency effects on enterprises of the liberalization of private sector activity, reductions in government subsidies, changes in ownership and control, bank restructuring, and changes in competitive pressure.

One set of models focuses on managerial career concerns as a key mechanism by which good managers of SOEs are separated out from bad ones, and by which the good ones are induced to restructure. Roland and Sekkat (2000) show that the existence of a private sector offering outside opportunities to the manager (career prospects) is necessary to eliminate the 'ratchet effect' for state enterprises, whereby the government was unable to commit itself not to increase the targets of enterprises performing well, and to elicit effort (restructuring) from good managers. They note that when the skills of the manager are asset-specific - which may be quite common in SOEs - the prospect of privatization rather than simply the existence of a private sector is necessary to induce restructuring by good managers. Moreover, the manager must have the possibility of securing some rents from privatization which means that some component of insider privatization is required.

Based on the first formal model of restructuring by Aghion and Blanchard (1994a), Kotrba (1996) shows that a separating equilibrium will prevail in which only good managers engage in restructuring (the socially optimal configuration) if it is assumed that there is a competitive bidding process for enterprises in which rational new owners participate. A 'rational new owner' is defined as one who would keep on a good manager who had revealed his or her quality through pre-privatization restructuring.

The aspect of restructuring at the heart of the Aghion-Blanchard-Burgess model is the inter-temporal problem posed by the fact that restructuring incurs a cost in the first period - not simply in terms of effort or managerial disutility, as in Roland and Sekkat, but in terms of output and employment. Restructuring is seen to involve cutting employment and there is no gain in output with which the 'losers' from restructuring could be compensated. Restructuring, therefore, represents a threat to managers if, for example, workers are sufficiently powerful to throw out a 'restructuring manager'. Benefits from restructuring are uncertain and, in any case, only come through in the second period and the reasonable assumption is made that managers cannot borrow to ease the passage of first-period restructuring. In this model, restructuring can be promoted by policy measures that increase the threat to the manager's survival if he or she does not restructure. This highlights the crucial role of the hardening of the enterprise budget constraint. Even if the threat of closure through bankruptcy or liquidation is rather remote (as it has been in most transition economies), the elimination of subsidies poses a threat to the manager since it impinges on his or her ability to pay employees and to pay for inputs. Although the absence of any threat of exit via bankruptcy was perceived as a major source of inefficiency in the pre-reform economies, formal bankruptcy was unlikely to be useful practical device for restructuring enterprises under the conditions of transition. The experience in market economies of a 'liquidation-bias' of bankruptcy suggested that in the transition context of output collapse and widespread loss-making, the likelihood of destroying potentially valuable activities would be too great (van Wijnbergen 1996).

If banking-sector reform is neglected, then the pressure for enterprise restructuring may be eased through access to soft loans (e.g. Portes and Begg (1993); Aghion *et al* (1996). The successful delegation of restructuring to the banks is constrained by the accumulation of non-performing loans by banks, which undermines the incentive of the bank to monitor loans because refusal to roll them over threatens the capital base of the bank. Because of the systemic threat to the banking system, bank managers can pursue a soft-loan strategy in the expectation of a bail-out by the government. Hence, the imposition of a very tough policy on the banks, such as firing the bank manager in the event of recapitalization, presents risks, since the manager will be induced to disguise the extent of the bad loan problem and roll over bad loans. A softer approach towards managers of banks runs the opposite risk - namely, that too many loans would be identified as non-performing, producing more liquidations than is socially efficient (Aghion *et al* 1996). To deal with this problem, it is suggested that non-performing loans be transferred from the portfolio of the bank to a special 'hospital' agency. The feasibility of creating appropriate incentives for such an agency has been questioned (Van Wijnbergen, 1996).

The theme that either too lax or too tough a policy can undermine incentives is taken up by Perotti (1998), who has examined the interaction between monetary policy and the expansion of inter-enterprise indebtedness. Excessively tight credit policies can be self-defeating and promote increased inter-enterprise debt if good managers refrain from restructuring because they come to believe that a general bail-out is likely.

A successful initiation of enterprise-sector reform thus requires a hardening of enterprise budget constraints, so that enterprises are denied access to subsidies or soft loans to finance losses, that private entrepreneurship is encouraged, and, in the case of asset-specific skills of managers, that privatization of SOEs is in prospect. A privatization process in which managers have some confidence in the existence of competitive bidding by 'rational new owners', or where the method of privatization promises some rents to the managers, is necessary. The process whereby good managers are separated from bad ones and engage in restructuring can be undermined (or reversed) if good managers come to believe that general bail-outs of the banks will occur. Hence macroeconomic policy and banking reform must be neither too lax nor too tough. All of these models assume the existence of sufficient competition in the product market to make survival at the *status quo* difficult.

The other major direction in theoretical work has been to model the consequences of different models of privatization for post- rather than pre-privatization behaviour. The new issue raised by transition that has prompted formal modelling efforts is the consequences of insider privatization for dynamic efficiency. Otherwise, the literature on transition has drawn both on the long-standing body of analysis of the employee-owned enterprise and on the literature from the principal - agent tradition on corporate governance and ownership structures. The Aghion-Blanchard (1996) model shows that if deep restructuring (assumed to be necessary for growth) requires both external finance and further labour-shedding, then insider privatization should be avoided. If this is not possible for political reasons, then employee-ownership with freely tradable shares is shown to be preferable to manager-ownership as a way to avoid entrenchment of bad managers. Moreover, the worse is the state of the outside labour market, the slower will be the rate of transfer from inside to outside ownership, since insiders will be worried about the implications of a change in control for their jobs, and hence the lower will be the dynamism of the enterprise sector as poor managers remain entrenched. This analysis highlights a trade-off associated with insider privatization: if the state retains ownership, the option of sale to an outsider is kept open, whereas insider-privatization may serve to entrench poor managers.

2.3.3. Enterprise Restructuring and Firm's Performance

Dimensions of Restructuring

As we see from the mentioned above, restructuring encompasses multiple forms of change in organizations, which can be grouped into three different categories: portfolio restructuring, financial restructuring and organizational restructuring (Bowman and Singh 1993; Gibbs 1993). Portfolio restructuring may occur through the sale or spin-off of lines of business as well as mergers and acquisitions. Financial restructuring encompasses leverage buyouts (LBOs), stock repurchases, and employee share ownership programmes (ESOPs), equity carve-outs, or recapitalizations. Organizational restructuring intends to increase efficiency through changes in organizational structure, internal reorganizations, or downsizing. The consequences of restructuring can be conceptualized in terms of a sequence of intermediate effects, which may have positive or negative outcomes. In the case of portfolio restructuring, these intermediate effects could be increased strategic focus, greater economies of scope, and more cogent control of multiple business units. In the case of financial restructuring, these intermediate effects could be an emphasis on cash flows and changes in managerial incentives. In the case of organizational restructuring, these effects could be greater employee satisfaction, reduced turnover, increased efficiencies, and better communication.

Studies of enterprise restructuring in transition economies have also been interested in another types of restructuring such as defensive and strategic restructuring, pro-active and negative restructuring (Grosfelf and Roland 1997; Frooman 1997; Linz and Krueger 1998). The findings of studies show that different types of restructuring do have different impact on firm performance.

Defensive Restructuring vis-? vis Strategic Restructuring

Grosfeld and Roland (1997) introduce the distinction between two types of restructuring: defensive and strategic restructuring. The "defensive" part of restructuring means basically taking measures aiming to reduce costs and scale down enterprise activity: cutting the obsolete production lines, shedding labour, getting rid of non-productive assets, etc. These measures defensive are in the sense that their primary goal is the immediate survival of the enterprise. Defensive restructuring does not as such necessarily imply the existence of a strategy for reorienting enterprises the activity under the new economic conditions. It may be done as a result of survival-oriented behaviour of managers and workers. However, it may also constitute the painful but necessary initial ingredient of a term strategic plan aiming at maximizing the enterprises value.

The "strategic" part of restructuring is based on a thoughtful business strategy responding to the necessity of a profound redeployment of assets. It implies the introduction of new product lines and new processes, new technologies and new investments. It necessitates a great deal of entrepreneurial skills and imagination, a good judgment about investment opportunities and adequate incentives. It also requires sources of finance for the new projects. New investments can be financed from the firm's retained earnings, or via financial markets through bank credit and/or issuing of equity and debt on the market. Even though in developed market economies most investments are financed from retained earnings (Mayer and Alexander 1990) insufficient financial allocation across agents has adverse effects on growth and macroeconomic performance (Roubini and Sala Martin 1992; Levine and Zervos 1993). In the case of Central and Eastern European countries, the adverse effects of financial misallocation are likely to be much stronger than in normal market economies because of the bigger change in the structure of output that must take place. For the same reason, accumulated debts or surpluses from the past, that directly affects enterprises capacity of self-financing, are not a good indicator of future financial prospects. Strategic restructuring inside enterprises is thus intimately linked to the degree of development of the financial sector and the change in corporate governance.

Defensive restructuring must not necessarily precede strategic restructuring. Both parts should be done more or less simultaneously. The conceptual distinction between these two types of restructuring is seful because they address both different problems and do not require the same instruments and skills to be conducted successfully. Success in defensive restructuring does not necessarily mean that the enterprise can be able to successfully reorient its business activities. Defensive restructuring may ultimately lead to curtailing of all activities and enterprise closure. Deciding redundancies requires overcoming the resistance of workers but can be done by managers who are convinced that layoffs are necessary and cannot be prevented by bailout subsidies from government. Different skills and institutions are required in order to ensure success in strategic restructuring. Managers with good investment projects should have opportunities to get adequate finance and investors must have adequate incentives to select and monitor the implementation of the projects.

Building on the studies done by Grosfeld and Roland (1997), Aghion, *et al* (1997); Frydman *et al* (1999), Domadenik and Vehovec (2002) develop a theoretical framework and empirically estimate of the extent of several forms of restructuring in the privatized firms in a model transition economies such as Croatia and Slovenia. In view of the institutional developments in the transition economies, they divided restructuring into defensive (related to short-term cutting costs) and strategic (focused on increasing revenues through investment). Using predictions from the theoretical framework, they estimated a firm-level labour demand equation to test defensive restructuring and an augmented investment equation to assess strategic restructuring. The labour demand estimates point to relatively slow defensive restructuring, while the investment model estimates indicate the presence of credit rationing and bargaining in most types of soft investment. The research didn't find support for the hypothesis that firms treat expenditures on employee training as investment, but there was evidence that they behave similarly as those from developed countries in that they display features of profit maximizing behaviour.

Proactive restructuring vs. negative restructuring

A common theme in the burgeoning literature on transition economies highlights the importance of enterprise restructuring in successfully completing the transformation from plan to market. In its most general specification, enterprise restructuring is described as "the process that enables a firm to operate successfully in a market economy" (Ernst 1996). This process may be initiated by the firm: "proactive restructuring" (Krueger 1995). It may include activities that ultimately result in resources going to their highest valued use: "positive restructuring" (Jeffries 1996). Earle and Estrin (1996) describe "short-term restructuring" as reductions in the labour, energy and material intensity of production -- without offsetting increases in capital intensity -- to raise the overall efficiency of enterprise operations. To the extent that restructuring activities initiated by the firm take into account a long-term perspective, that is, are directed toward maximizing the long-run value of the firm, the process is termed "strategic restructuring" (Ernst *et al* 1996); or "long-run restructuring" if firms undertake investment in new capital to improve production techniques or implement new R&D incentives (Earle and Estrin 1996).

Privatized firms "seeking to change as little as possible while retaining substantial insider control" (Ash and Hare 1994) are categorized as in a "defensive restructuring" mode. The general consensus in the literature is that the duration of transition will be prolonged if firms pursue a "wait and see" strategy with regard to the continued availability of government subsidies - "passive restructuring" (Sutela 1994; Linz and Krueger 1996; Ernst et al 1996), or if the manager exploits the firm's assets for short-term gain - "negative restructuring" (Ellman 1994, Jeffries 1996). In such instances, the overall cost imposed by the transition process will increase.

The mechanics of restructuring incorporate a wide range of activities. Blasi

(1997) lists nearly seventy "important numbers on restructuring". Perhaps more than anything else, Blasi *et al* (1997) highlight the fact that the existing literature on enterprise restructuring in transition economies is in anything but agreement when it comes to identifying, much less quantifying, the changes required for former state-owned enterprises to survive in the post-transition economy. For example, in one of the earliest studies of Russian firms, Commander (1993) focuses on physical indicators: changes in output and employment, and on financial indicators: enterprise sales and profits, as a measure of the extent of enterprise restructuring. In one of the more recent studies, Earle and Estrin (1997), using data compiled by the World Bank, develop an index of restructuring that aggregates numerous dimensions into a single weighted variable. They use this index, as well as improvements in labour productivity, as a dependent variable to be explained by a variety of independent variables, including ownership structure and industry. An important contribution of their work is the explicit recognition of the endogeneity between restructuring and ownership structure in transition economies.

Carlin and Colin (1992) evaluates alternative forms of corporate restructuring. It emphasizes differences in the sequence in which reforms are undertaken in different countries. In some countries, restructuring is being undertaken by the state before privatization; in some, restructuring is delegated to private-sector institutions before shares are offered to the public at large; and in others, public offers of shares are preceding restructuring. The article suggests that the recent theoretical literature on corporate ownership and vertical integration provides a useful framework for evaluating alternative sequences of reform. These points to four factors as being central to the reform process: contractual incompleteness between the state, investors and managers; complementarity between the assets of different stakeholders; the relative importance of assets; and the relative abilities of different stakeholders. The continuing role for the state in Eastern Europe is attributable to difficulties of contracting between the state and private firms and the complementarity between the assets of state and firms. The slow pace of privatization is due to poor public finances and inefficient bureaucracies. There is one country in which a substantial amount of restructuring has been undertaken by both the state and the private sector, however: East Germany. This paper documents in some detail the privatization process in East Germany. It notes that five parties have been central to the reform process: the state, the Treuhandanstalt, banks, Western companies and the incumbent management. It records a gradual transfer of control from the state to the management of firms. It argues that the central role played by banks and companies in restructuring reflects an important complementarity between their assets and those of former state-owned enterprises, and the fact that they can offer valuable advice to East German management. This raises the question of what East European countries that do not possess institutions with equivalent skills and resources should do. The experience of East Germany suggests that careful attention should be given to the governance of state agencies and private-sector institutions. The role of financial institutions in funding restructuring should be supplemented by non-financial companies providing management advice. Risk capital will not be available, initially, until East European enterprises have acquired adequate collateral or reputations. In the mean time, international agencies will play a central role in funding the transition.

Measurement of enterprise restructuring

Ericson (1998) argues that conceptually, restructuring of an enterprise must involve some substantial change in the organization, activities and relationships in which the enterprise is involved. But to be analytically useful, the concept of restructuring must also involve a specific conscious orientation and motivation towards success in a future market environment, as well as significant change in operations and interactions. In the highly volatile environment of the Russian, or indeed any other, transition, industrial enterprises will inevitably be making many changes in how they function and with whom they deal, just as a matter of continuing operation. Some changes will be largely forced by the behaviour of interlocutors, and some will be actively chosen by the enterprise management. Some will develop or further the capability for, and hence the probability of, success in the evolving (future) market environment, while others will enhance the chances of survival on the basis of existing capabilities and connections, whether recently developed or inherited from the Soviet era. Each of these kinds of changes will have a broad impact on measurable outcomes, and unless they are purely forced by circumstances those changes will generally be positive. Yet, they do not all constitute "restructuring" in an economically meaningful sense.

An analytically useful concept of restructuring in the transition from a Soviet-type to a market-based economy should therefore capture a far deeper process that any reflected in typically available, at least in transition economies, statistics. This creates serious conceptual problems in identifying and measuring it, a number of which are discussed in the Linz and Krueger (1998) piece. As true restructuring involves adjustment to market conditions, it should be reflected in improvements in market values of the enterprises activities. Possible indicators might then involve profit (-ability), labour or general factor productivity, and/or sales increases, or reductions in unit costs or input intensities. All of these suffer, in the conditions of transition, from the high volatility and often arbitrariness of prices in which all measures of not perfectly homogeneous inputs and outputs must he made. Indeed, even labour productivity suffers from the need to aggregate output of any industrial firm in some prices, as well as the heterogeneity of the input in terms of type, skill, quality, etc. Of course, the problems are only worse with using any measure involving profit or capital, even if accounting data were available for Russian firms. One measure that might be marginally better than others when output is relatively homogeneous, but which I have not seen used in the literature, is unit cost reduction. This might capture more of the process and technology side of restructuring than the more output oriented measures typical in the literature.

Ericson (1998) also emphasizes that any measurement must also deal with the problem that there is far more going on in the transition than just adjustment of the enterprise to the future market. Both initial conditions and broader industry-wide and macroeconomic processes affect any measure that one might use to capture the extent of industrial restructuring at the enterprise level. Thus it is necessary with any measure to explore possible alternative explanations. For example, the ability to consistently pay wages above the industry average is as apt to reflect transition disequilibrium phenomena and/or special rents as it is to indicate restructuring, particularly when it is unaccompanied by substantial real investment. The quality of inherited capital (imported? recently installed? etc.), inherited monopoly power, the type of product, access to retail (cash) outlets, etc., as well as active asset stripping and financial manipulations on GKO, money and exchange markets, could all support above average wages in the chaotic environment of the transition. Similarly, substantial improvements in labour productivity need not arise from "pro-active" restructuring, particularly when accompanied by a substantial drop in output. They may instead measure extraordinary prior inefficiency, and thus arise from the elimination of redundancy and waste, from survival retrenchment without active restructuring. This would make "industry" a strong explanatory factor in any regression attempting to isolate the sources of productivity change. In particular, one might suspect this when improvements are concentrated in the Soviet priority sectors such as power, fuel, machine building, construction materials and chemicals, where access to inputs and capital was far less a problem than in less favoured sectors.

Such measures may still be correlated with real restructuring. But to be convincing, these other explanations should be pursued and rejected, and other, more direct, indicators that actual restructuring is taking place should be presented. The presence of positive real investment, break-ups and/or spin-offs, new operating divisions and/or merger activity, and switches in (sub-) industry, as well as significant changes in management, product assortment, suppliers and retailers would provide clear supporting evidence for "pro-active" restructuring.

Measurement of Firm's Performance

A large and rapidly growing body of the literature has focused on study of the impact of enterprise restructuring on firm performance from different perspectives such as ownership types and concentration, ownership control, competition, corporate governance, etc. For instance, Carlin *et al* (2001) studied 3,300 firms in 25 transition countries to investigate the factors that influence restructuring by firms and their subsequent performance and analyze the impact on performance of ownership, soft budget constraints, the general business environment and a range of measures of the intensity of competition as perceived by a firm.

Most of the literature considers that corporate ownership structure has a significant effect on corporate governance and performance. More recently, the focus of the literature has shifted and several theories have been proposed to show the ambiguity of the effect of ownership concentration. The study of La Porta, *et al* (1999) shows that, in the majority of countries, large corporations have large shareholders who are active in corporate governance. Consequently, they argue, monitoring managers is not the main problem of corporate governance and the real concern is the risk of the expropriation of minority shareholders. A similar view has been expressed by the Becht and Roell (1999) in their review of corporate governance in continental European countries. In most of the countries studied, companies have large shareholders and the main conflict of interest lies between them and minority shareholders. On the other hand, dispersed ownership may have a beneficial impact on firm performance. If concentrated ownership provides incentives to control the management, it may also reduce the manager's initiative or incentives to acquire information (Aghion and Tirole 1997). In this perspective, Burkart, *et al* (1997) view dispersed ownership as a commitment device ensuring that shareholders will not exercise excessive control. If the principal is concerned with providing the manager with the guarantee of non-intervention, he may choose to commit not to verify.

Bevan (1999) takes the form of a comparative study of the body of research upon enterprise performance and restructuring in established market economies and transition economies. Issues related to empirical studies of enterprise performance and restructuring were examined, including the influence of historical cost accounting, reverse causality, sample selection bias and transition specific factors.

Typically, improvements in firm performance would be reflected by such factors as increased profitability, efficiency improvements, and possibly increased output, whilst restructuring would be reflected by such factors as investment spending on fixed capital and/or assets. However, of these, the wealth of literature that has emerged which analyses Western market economies has traditionally focused upon measures of enterprise profitability and efficiency.

The majority of applied studies utilize profitability indicators in one of two ways. The first approach is to look at the return to the total capital of the firm - the return to both equity holders and debt holders combined, i.e., the entire liability side of the balance sheet. In this case, profit is measured before deduction of interest. The standard accounting ratio to measure profitability in this case is operating profit-earnings before interest, tax and depreciation - as a percentage either of sales, or as a percentage of total assets. The second approach is to look at the return accruing only to equity holders. This means that interest charges (the cost of debt) is treated as a cost. The usual accounting ratio used here is profit after interest and depreciation (usually before tax), as a percentage of equity (the rate of return on equity).

In the comparative study of the performance of private, state-owned and mixed US enterprises, Boardman and Vinning (1998) use four alternative profitability measures, namely net income, return on equity, return on assets and return on sales, whilst identical indicators are used by Megginson, Nash, and van Randenborgh (1994) in their study of the performance of newly privatized enterprises. As Boardman and Vining (1998) note, the nature of historical cost accounting conventions such as the treatment of depreciation, and the timing of profits and capital expenditure causes the latter three accounting ratios to differ from economic rate of return. However, in defence of such measures they cite previous research which has illustrated that such accounting ratios are sufficiently highly correlated with economic rate of return to be regarded appropriate proxies.

Most applied studies (Boardman and Vining, 1989; Megginson *et al*, 1994; Vining and Boardman 1992) also examine changes in efficiency in terms of labour productivity. Given that labour productivity may be reflected as the ratio of total output (or sales) to labour employed its use as a measure of performance is consistent, in that it will be correlated with total factor productivity and hence profitability.

When deriving the above indicators, it was implicitly assumed that the level of capital employed (and hence the level of equity in capital) remained fixed; given that this assumption represents the traditional economic distinction between the short and long run, analysis was therefore of short-run indicators. Consequently we regard short-run restructuring behaviour to include measures which reorganize those components of the input bundle which are deemed to be variable in the short run, without influencing the level of capital employed by the firm, which narrow product lines, and so on. Whilst introducing such a distinction between short-run and long-run restructuring behaviour however, we should stress that restructuring remains a dynamic phenomenon. These short run developments may therefore be broadly categorized as cost reduction measures, which improve the efficiency of the firm and hence increase profitability and the aforementioned performance indicators. By contrast, long-run restructuring is generally related to revenue enhancing measures, such as changes in the internal structure of the organisation, and investment in capital, which will again lead to improved performance. Hence, when Megginson *et al* include two alternative measures of capital investment (capital expenditure to sales and total assets respectively) in their analysis, they attempt to analyze long-run restructuring measures at the enterprise level.

Whilst investment may be regarded as a prerequisite for long-run restructuring and performance, it is also considered to be a necessary but not sufficient condition: investment spending must be well targeted to enable the future development of the enterprise. In this regard, long-run estimates of expected firm performance may be reflected by the valuation which financial markets place upon the continuation of the firm. Many Western studies have used Tobin's Q (or more precisely the 'market to book ratio' as a proxy for Q) as a measurement of expected long-run enterprise performance (see, for example, (Rajan and Zingales 1995). Tobins' Q effectively illustrates the valuation of the firm in terms of its replacement value, and is calculated as the ratio of the market value of the enterprise (value of equity plus debt) to the replacement value of the assets of the enterprise. Thus higher values of Q illustrate that the firm is considered to be more valuable as a going concern than as a collection of individual assets. Notably, however, as Tobin's Q depends upon the market valuation of the firm and hence the expectations of the financial markets, its reliability is dependent upon financial markets being fairly well developed.

Furthermore, inflation has a variable impact on the market to book ratio as it will artificially reduce the book value but not the market value of capital, and hence in order to establish reliable measures of Q it is necessary that the economy under study is relatively stable at the macroeconomic level.

A final factor relating to measured profitability can be seen by noting that in equation (1) above, we have treated w, the wage paid to labour, or more precisely, to the employees working within the firm, as exogenous and entirely market-determined. A common theme in the Western literature on wage determination and corporate governance is that this assumption is often violated - both workers and managers are often able to appropriate profits in the form of higher wages or other remuneration or rewards. In this event, although the textbook short-run profit function suggests a negative correlation between wages and profits, a positive correlation may in fact be observed, as a result of the power which insiders have to expropriate profits. Under these circumstances the causal route is reversed, to run from profits to wages. Moreover, the extent to which these 'rents' are then allocated between increased wages and employment is the subject of a large literature which examines the bargaining process and objectives of the insiders. Whilst we return to these issues in Section 4 below when considering the relation between corporate governance and enterprise performance, here we additionally note a resulting example of the caution which may need to be exercised when interpreting empirical evidence. Rather than reflecting insider power, it may be that a measured positive correlation between wages and profits simply reflects labour quality, as firms are required to pay higher wages in order to attract more productive or skilled staff which in turn increases profits.

2.4. Corporate Governance

In the last two decades, corporate governance issues have become important not only in the academic literature, but also in public policy debates. During this period corporate governance has been identified with takeovers, financial restructuring, and institutional investors' activism (Zingales 1998). Many academic studies have attempted to investigate systematically what exactly corporate governance is, why there is a corporate governance "problem", what role takeovers, financial restructuring, and institutional investors play in corporate governance, particularly in the developed western economies (Freeman and Evan 1990; Jeffers 2005; Vinten 2001; Letza, *et al* 2004; Andrei and Robert, 1997; Zingales 1998; Williamson 1988; Hart 1995).

Much of the debate on corporate governance has centred on practical issues, including corporate fraud, the abuse of managerial power and social irresponsibility. In essence, the debate is about how to solve these perceived problems in corporate practice. For many commentators corporate governance is about building effective mechanisms and measures, either in order to satisfy current social expectations or to satisfy the narrower expectations of shareholders (Letza, *et al* 2004; Fahy, Roche, and Weiner 2005).

2.4.1. Concept and Definition

In the corporate governance literature, there is a disagreement about the boundaries of the subject of corporate governance. Depending on their perspective, different authors define corporate governance in different ways. Corporate governance can be defined in a number of ways, from very broad to demonstrably specific.

According to Tricker (1994), corporate governance is an umbrella term that includes specific issues from interactions among senior management, shareholders, board of directors, and other corporate stakeholders. In its narrowest sense, corporate governance can be viewed as a set of arrangements internal to the corporation that define the relationship between the owners and managers of the corporation, for example, Monks and Minow (2003) define corporate governance as the relationship among various participants in determining the direction and performance of corporations, which include the primary participants such as the shareholders, the management, and the board of directors.

Iskander and Chamlou (2000) in the World Bank define corporate governance from two different perspectives. From the standpoint of a corporation, the emphasis is put on the relations between the owners, management board and other stakeholders (the employees, customers, suppliers, investors and communities). Major significance in corporate governance is given to the board of directors and its ability to attain long-term, sustained value by balancing these interests. From a public policy perspective, corporate governance refers to providing for the survival, growth and development of the company, and at the same time, its accountability in the exercise of power and control over companies. The role of public policy is to discipline companies and, at the same time, to stimulate them to minimize differences between private and social interests.

From the perspective of stakeholder theory, OECD (2004) claims that corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance. Corporate governance is affected by the relationships among participants in the governance system. Controlling shareholders, which may be individuals, family holdings, bloc alliances, or other corporations acting through a holding company or cross shareholdings, can significantly influence corporate behaviour. As owners of equity, institutional investors are increasingly demanding a voice in corporate governance in some markets. Individual shareholders usually do not seek to exercise governance rights but may be highly concerned about obtaining fair treatment from controlling shareholders and management. Creditors play an important role in a number of governance systems and can serve as external monitors over corporate performance. Employees and other stakeholders play an important role in contributing to the long-term success and performance of the corporation, while governments establish the overall institutional and legal framework for corporate governance.

Another perspective in defining corporate governance is called 'path dependence'. Central to the idea of path dependence is that initial historical conditions matter in determining the corporate governance structures that are prevalent today. A national system of corporate governance evolves in order to exploit the advantages of the corporate form of organization while mitigating concomitant agency costs in a manner consistent with a country's history and legal, political, and social traditions (Gedalovic and Shapiro 2002). Therefore, a nation's system of corporate governance can be seen as an institutional matrix that structures the relations among owners, boards, and top managers, and determines the goals pursued by the corporation. The nature of this institutional matrix is one of the principal determinants of the economic vitality of a society (Davis and Useem 2001). In order to understand the problem of corporate governance, it is most important to stress that it is, first of all, dependent on the political system of any country and the country's historical and cultural characteristics.

Kuhndt *et al* (2004) presents the concept of Responsible Corporate Governance (RCG). RCG is defined as a stakeholder-oriented policy approach allocating responsibilities to societal actors, who will drive corporate accountability. According to this view, corporations, aiming at accountability to the societal actors in terms of their sustainability efforts, shall follow these principles: assume societal leadership for responsibility; identify clearly and specifically their social, environmental and economic values in accordance with the demands of their stakeholders; define their social, environmental and economic priority areas for action; adopt specific management practices to integrate these values into their operations and take measurable action;

disclose comprehensive data on their social, environmental and economic impacts; involve in comprehensive review of their activities; strive for continuous learning. According to their view, the core elements of RCG are: (1) Stakeholder empowered corporate governance; (2) Management and performance evaluation systems; (3) Transparency enhancement; (4) Stakeholder verification. These elements have been deducted from the initiatives of environmental NGOs (ENGOs), Intergovernmental Organisations (IGOs), financial institutions, research institutions and multi-stakeholder organisations. These actors support one or more of these principles for corporate accountability, while RCG, as a supportive policy instrument, aims at gathering all of these principles under one roof.

Fahy *et al* (2005) argue that enterprise governance is based on the principle that good governance alone cannot make an organization successful. Thus, they propose the emerging framework which is under three dimensions of Performance, Conformance and Corporate Responsibility. The framework addresses the primary concerns that boards and senior executives must effectively manage to ensure the delivery of long-term value to stakeholders. They claim that in the framework, performance and conformance are interchangeable; performance can lead to assurance and conformance to value creation. Neatly bridging the two principles is the corporate responsibility. Inextricably linked to corporate governance and risk management, as well as 'ethical' environmental and social stewardship, on which its origins are founded, CR has fast gained considerable significance for stakeholders and the corporate community. Although the emerging concept of Enterprise Governance originally focused on the conformance and performance dimensions, we believe that CR is of sufficient importance to create a third element within the framework. Furthermore, evidence shows that sustainable value can only be successfully achieved with the adoption of all three disciplines; as Dell, Microsoft, Tesco, GE and Alcoa, to name but a few, can testify.

Obviously, corporate governance involves a set of relationships between a company's management, its board, its shareholders and its stakeholders. It concerns relationships among the management, board of directors, controlling shareholders, minority shareholders and other stakeholders. It deals with the rights and responsibilities of a company's management, its board, shareholders and various stakeholders. Thus, corporate social performance can be analyzed and evaluated more effectively by using a framework based on the management of a corporation's relationships with its stakeholders than by using models and methodologies based on concepts concerning corporate social responsibilities and responsiveness (Clarkson 1995). Good corporate governance should strive to combine the different mechanisms in a way that balances the desire to protect different stakeholders of the firm against the need to give managers and controlling owner's sufficient incentives and freedom to manoeuvre. The corporate governance literature increasingly recognizes that fairness of treatment, job satisfaction, high quality of work environment and particularly income and job security are important factors in generating investments in firm-specific capital by employees (Blair 1995; Kelly and Parkinson 1998; Slinger and Deakin 2000).

The following section will analyze two different models of corporate based on agency and stakeholder theory.

2.4.2. Corporate Governance Models

As current analyses on corporate governance approach the governance issue from different perspectives and base their views on different assumptions and presuppositions, there exist quite diverse theoretical models, which can be identified in the literature. Major surveys and/or reviews of corporate governance models have been conducted by Turnbull (1997); Shleifer and Vishny (1997); Keasey *et al* (1997); Hawley and Williamson (1996). Hawley and Williams (1996) suggest four major views in the corporate governance debate in the US, i.e. the finance model, the stewardship model, the stakeholder model and the political model. The dominant model in the late 20th century is the finance view of corporate governance, which is concerned with a universal agency problem and how to adopt appropriate incentive systems and/or the mechanism of takeover to solve this problem. While the finance model is focused on shareholder rights and control in publicly held corporations, Shleifer and Vishny (1997) extend the finance view of the firm to include not only shareholders, but also debt-holders and bankers. In contrast to the dominant finance model, the stewardship model (see Donaldson and Davis 1994) assumes a different nature of agent/managerial behaviour and argues that managers are trustworthy and should be fully empowered. The stakeholder model further extends the purpose of the corporation from maximizing shareholders wealth to delivering wider outputs to a range of stakeholders and emphasizes corporate efficiency in a social context. Departing from the prevailing economic analysis of corporate governance, the political model (e.g. Pound 1992; Pound 1993), according to Hawley and Williams (1996), is a non-market approach for monitoring management, such as shareholder democracy and negotiation.

In this research, I attempt to capture the central arguments, core assumptions and philosophies of the shareholding and stakeholding perspectives respectively, from which the sharp differences on assumptions and presuppositions between the two perspectives are clearly observed. These analyses are necessary for my further questions about how the impact of different models of corporate governance on social performance of enterprise restructuring.

The Shareholder Model

The shareholder model (also called outsider system) constitutes the classic means of regulation in the Anglo-Saxon countries. The U.S., U.K and Ireland fit into this category, although there are differences between these countries. According to this model, firms are set up to maximize shareholders' wealth and the main criterion of performance is usually their market value. This approach associates corporate governance with the principal-agent theory. Paid managers are all-powerful, as opposed to dispersed shareholders. The level of information enjoyed by these corporate leaders and shareholders is completely unequal, and the costs for the principals (the shareholders) to act in relation to their agents (the managers) can run quite high. Control of the action of the corporate leaders is exerted through external market mechanisms.

According to the shareholder model the objective of the firm is to maximize shareholder wealth through a locative, productive and dynamic efficiency i.e. the objective of the firm is to maximize profits. The criteria by which performance is judged in this model can simply be taken as the market value (i.e. shareholder value) of the firm. Therefore, managers and directors have an implicit obligation to ensure that firms are run in the interests of shareholders. The underlying problem of corporate governance in this model stems from the principal-agent relationship arising from the separation of beneficial ownership and executive decision-making. It is this separation that causes the firm's behaviour to diverge from the profit-maximizing ideal. This happens because the interests and objectives of the principal (the investors) and the agent (the managers) differ when there is a separation of ownership and control. Since the managers are not the owners of the firm they do not bear the full costs, or reap the full benefits, of their actions. Therefore, although investors are interested in maximizing shareholder value, managers may have other objectives such as maximizing their salaries, growth in market share, or an attachment to particular investment projects, etc.

An effective corporate governance framework can minimize the agency costs and hold-up problems associated with the separation of ownership and control. There are broadly three types of mechanisms that can be used to align the interests and objectives of managers with those of shareholders and overcome problems of management entrenchment and monitoring:

– One method attempts to induce managers to carry out efficient management by directly aligning manager's interests with those of shareholders e.g. executive compensation plans, stock options, direct monitoring by boards, etc.

– Another method involves the strengthening of shareholder's rights so shareholders have both a greater incentive and ability to monitor management. This approach enhances the rights of investors through legal protection from expropriation by managers e.g. protection and enforcement of shareholder rights, prohibitions against insider-dealing, etc.

– Another method is to use indirect means of corporate control such as that provided by capital markets, managerial labour markets, and markets for corporate control e.g. takeovers.

One of the critiques of the shareholder model of the corporation is the implicit presumption that the conflicts are between strong, entrenched managers and weak, dispersed shareholders. This has led to an almost exclusive focus, in both the analytical work and in reform efforts, of resolving the monitoring and management entrenchment problems which are the main corporate governance problems in the principal-agent context with dispersed ownership. For example, most of this work has addressed concerns related to the role of the board of directors, stock options and executive remuneration, shareholder protection, the role of institutional investors, management entrenchment and the effectiveness of the market for takeovers, etc.

Another critique of the shareholder approach is that the analytical focus on how to solve the corporate governance problem is too narrow. The shareholder approach to corporate governance is primarily concerned with aligning the interests of managers and shareholders and with ensuring the flow of external capital to firms. However, shareholders are not the only ones who make investments in the corporation. The competitiveness and ultimate success of a corporation is the result of teamwork that embodies contributions from a range of different resource providers including investors, employees, creditors, suppliers, distributors, and customers. Corporate governance and economic performance will be affected by the relationships among these various stakeholders in the firm. According to this line of argument, any assessment of the strengths, weaknesses, and economic implications of different corporate governance frameworks needs a broader analytical framework which includes the incentives and disincentives faced by all stakeholders.

The Stakeholder Model

In the stakeholder model (also called insider system), the financial markets are little developed; the capital structure of the public corporations is characterized by the presence of a small number of major stockholders who hold controlling blocks of shares. Traditionally, these stockholders (banks in Germany, public or private financial institutions, and industrial corporations in France) protect the managing teams in place from the threat of hostile takeover bids. The activities of the company are guided on the basis of mechanisms in which players with privileged access to information exert their influence on corporate decisions. They are insiders.

According to the stakeholder model, corporate governance is primarily concerned with how effective different governance systems are in promoting long term investment and commitment amongst the various stakeholders (see Williamson 1985). Kester (1992), for example, states that "the central problem of governance is to devise specialized systems of incentives, safeguards, and dispute resolution processes that will promote the continuity of business relationships that are efficient in the presence of self-interested opportunism". Blair (1995) also defines corporate governance in this broader context and argues that corporate governance should be regarded as the set of institutional arrangements for governing the relationships among all of the stakeholders that contribute firm specific assets.

Although Berle and Means (1932) are usually presented as the first theoreticians of the shareholder model, in fact it was the first expressions of the stakeholder perspective that could be found in their writings when they defended the concept that employees, suppliers, customers and members of the communities in which the firms are located also have stakes in the firm. The creation of shareholder value is not the only goal assigned to the managers, who are more inclined than in the shareholder model type to humour the interests of various parties involved with the company (banks, public shareholders, employees, etc.). The view of the corporation in continental Europe recognizes a public interest in how large firms are managed. In most of these countries, corporations are considered not just to be private associations of shareholders. They are seen as having obligations not just to their shareholders but also to society at large.

In this model, hostile takeovers are few and long-term financial relations exist between the financial institutions and the companies. For minority shareholders the financial market does not function in a transparent manner. The process of allocating financial as well as human resources is more a question of internal management than of market mechanisms. The companies themselves become part of networks that allow them to develop customer/supplier relationships on the basis of implicit contracts that favour the long term. German capitalism, structured around the relationship between banks and industry, and careful to maintain a social dialogue in its companies, constitutes a typical example of this model of corporate governance.

The stakeholder model takes a broader view of the firm. According to the traditional stakeholder model, the corporation is responsible to a wider constituency of stakeholders other than shareholders. Other stakeholders may include contractual partners such as employees, suppliers, customers, creditors, and social constituents such as members of the community in which the firm is located, environmental interests, local and national governments, and society at large. This view holds that corporations should be "socially responsible" institutions, managed in the public interest. According to this model performance is judged by a wider constituency interested in employment, market share, and growth in trading relations with suppliers and purchasers, as well as financial performance.

The problem with the traditional stakeholder model of the firm is that it is difficult, if not impossible, to ensure that corporations fulfil these wider objectives. Blair (1995) states the arguments against this point of view: "The idea [...] failed to give clear guidance to help managers and directors set priorities and decide among competing socially beneficial uses of corporate resources, and provided no obvious enforcement mechanisms to ensure that corporations live up to their social obligations. As a result of these deficiencies, few academics, policymakers, or other proponents of corporate governance reforms still espouse this model."

However, given the potential consequences of corporate governance for economic performance, corporations should have responsibilities to parties other than shareholders. What matters is the impact that various stakeholders can have on the behaviour and performance of the firm and on economic growth. Any assessment of the implications of corporate governance on economic performance must consider the incentives and disincentives faced by all participants who potentially contribute to firm performance. With this in mind, the stakeholder model has recently been re-defined, where the emphasis has been to more narrowly define what constitutes a stakeholder. Therefore, the "new" stakeholder model specifically defines stakeholders to be those actors who have contributed firm's specific assets, see Blair (1995). This redefinition of the stakeholder model is also consistent with both the transaction costs and incomplete contract theories of the firm in which the firm can be viewed as a "nexus of contracts" (Williamson 1975; Williamson 1985). The "best" firms according to the "new" stakeholder model are ones with committed suppliers, customers, and employees. This new stakeholder approach is, therefore, a natural extension of the shareholder model. For example, whenever firm-specific investments need to be made, the performance of the firm will depend upon contributions from various resource providers of human and physical capital. It is often the case that the competitiveness and ultimate success of the firm will be the result of teamwork that embodies contributions from a range of different resource providers including investors, employees, creditors, and suppliers. Therefore, it is in the interest of the shareholders to take account of other stakeholders, and to promote the development of long term relations, trust, and commitment amongst various stakeholders (Franks and Mayer 1996). Corporate governance in this context becomes a problem of finding mechanisms that elicit firm specific investments on the part of various stakeholders, and that encourage active co-operation amongst stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises, see the OECD Principles of Corporate Governance (OECD 2004).

One of the critiques of the stakeholder model, or fears of participants in the reform process, is that managers or directors may use "stakeholder" reasons to justify poor company performance. The benefit of the shareholder model is that it provides clear guidance in helping managers set priorities and establishes a mechanism for measuring the efficiency of the firms' management team i.e. firm profitability. On the other hand, the benefit of the stakeholder model is its emphasis on overcoming problems of underinvestment associated with opportunistic behaviour and in encouraging active co-operation amongst stakeholders to ensure the long-term profitability of the corporation.

One of the most challenging tasks on the reform agenda is how to develop corporate governance frameworks and mechanisms that elicit the socially efficient levels of investment by all stakeholders. The difficulty, however, is to identify those frameworks and mechanisms which promote efficient levels of investment, while at the same time maintaining the performance accountability aspects provided by the shareholder model. At a minimum, this implies that mechanisms that promote stakeholder investment and co-operation should be adopted in conjunction with mechanisms aimed at preventing management entrenchment. Stakeholder objectives should not be used to prevent clear guidance on how the firms' objectives and priorities are set. How the firm will attain those objectives and how performance monitoring will be determined also need to be clearly defined.

2.4.3. Corporate Governance in Transition Economies

Corporate governance has increasingly become an important agenda of enterprise reforms in transition economies in recent years. It has also attracted more international organizations (OECD, World Bank) and academic researchers to investigate corporate governance issues in transition economies (Aoki and Kim 1995a; Filatotchev et al 2003; McGee and Preobragenskaya 2004; Pucko 2005; Urbanek et al 1997; Pannier 1996; McCarthy and Puffer 2002; William *et al* 2003; CLARKE 2003; Bai *et al* 2004; Mallin and Jelic 2000; Aoki and Kim 1995b).

Two aspects of post-communist reforms, privatisation and restructuring, have made the issues of corporate governance a very active area of research. Both are seen as key elements responsible for the success of transition. Privatisation was conceived as a crucial step towards efficiency by way of creating "effective owners" (Chubais and Vishnevskaya 1993). These were seen as a driving force that would assure the more effective employment of assets necessary to prove the superiority of the market mechanism of resources allocation over central planning. In fact, however, improvements in efficiency have been slow to materialize on the scale originally anticipated. As macro-economists were struggling to offer an unequivocal explanation of events it was not surprising to see concepts developed within microeconomics and organizational theory being increasingly put to use in transition studies. The investigation of corporate governance structures emerged as a promising avenue of research.

It is agued that the importance of sound corporate governance for transition economies can be explained through its four main influences: (1) creation of the key institution, the private corporation, which drives the successful economic transformation to a market based economy, (2) effective allocation of capital and development of financial markets, (3) attracting foreign investment and (4) making a contribution to the process of national development (Babic, 2001).

However, the development of corporate governance demands the establishment of certain market economy institutions necessary for economic growth. Without good corporate governance, corporations cannot fulfil their main missions of profit-making and contributing to the social welfare with maximum effectiveness. Companies cannot operate successfully without adequate rules of governance and the institutions that support them, or without the acceptance of a culture of corporate governance among managers, owners and other stakeholders.

For countries in transition, corporations and associated institutions are the key to successful economic transformation towards a market economy. Well-developed corporate governance requires that all relevant actors recognize and understand their roles. Mass privatization gives birth to numerous owners who are not active participants in ownership because they do not recognize their roles, rights and responsibilities. Most of them simply wait for the paying out of dividends, which are often worthless in their value. Also, managers do not understand their roles of agents when they are compared to owners, but they run companies as if they were their property, satisfying own interest to the detriment of owners and the company as a whole. Corporate governance requires coherent and strict legal regulations which imply an urgent mission for the makers of economic policies of countries in transition. Furthermore, it is important to provide for systems to recruit, train and reward professional managers who can be held to high standards of competency, ethics, and responsibility.

Main Issues of Corporate governance in Transition Economies

The issues of corporate governance in transition economies are mainly related to the efficiency of corporate governance mechanism. Roland (2000) draws a synthetic picture of corporate governance in transition with emphasis on the efficiency implications of corporate governance.

Problems with State Governance

The initial state of corporate governance in transition economy was that of state governance with which numerous inefficiencies were associated. A growing literature has tried to understand these inefficiencies.

A first strand of papers has emphasized the intervention of government to impose on managers political objectives such as the excess creation of jobs which create political benefits but create economic inefficiencies (Shleifer and Vishny 1994). State intervention is also related to the absence of commitment to given incentive schemes. Usually in contracts between private parties, the government (and the courts) acts as a third party to ensure contract enforcement and commitment to existing contracts. In the relations between the government and enterprises, there is no such third party and therefore the question of the commitment of government toward enterprises is an important issue. Specifically, this means that even if the government cares about efficiency from an *ex ante* point of view, its inability to commit may lead it to ex post intervention in enterprises that lead to ex ante inefficiencies. In the literature, this has been called the ratchet effect (Laffont and Tirole 1988; Roland 2000). In its most general form, the ratchet effect means that the government uses new information generated by firm behaviour to renege on its past commitments and "ratchet up" its demands on enterprises compared to its previous commitments. Well known examples of the ratchet effect are the ratchetting up of plan targets for enterprises that over-fulfil the plan too easily or the reduction of budgets of enterprises or divisions within organizations that do not spend all their budgets. The perverse incentive effects of the ratchet are well understood: agents keep slack in performance or overspend their budgets.

A second strand of papers has emphasized inefficiencies associated to state governance via the intervention of enterprises to obtain soft budget constraints (Dewatripont and Maskin 1995; Kornai 1980) and to seek rents. The important question raised is: What are the *mechanisms* by which privatization solves these problems? Economic theories today are far more precise than the slogans of "depolarization" that one has seen in the transition literature. The question is not trivial. Indeed the above problems can all exist with private firms. The state can, for example, intervene in private firms to impose objectives that deviate from efficiency. This is the case for example with inefficient regulations imposed on private firms. The government may renege on its commitment not only towards state-owned enterprises but also towards private enterprises. An obvious area where this applies is the field of taxation. It is a rather general feature of taxation that governments do not commit to given tax rates. Similarly, soft budget constraints and rent-seeking are not unique to SOE's. Private firms also lobby to get subsidies and to seek rents.

Economic theory has been trying to understand what the mechanisms are by which these problems are less prevalent in private firms as compared to state-owned firms. For example, the model of Shleifer and Vishny (1994) shows that state intervention in private firms is more costly than in state-owned firms because in private firms, deviations from efficiency imply important profit losses for the owners whereas managers of SOEs are depend on the state for their livelihood anyway and do not face such high important opportunity costs of accepting state intervention as private firms. Therefore, private owners must be paid more in order to be persuaded to deviate from profit objectives. Similarly, the commitment problem of the government can be made less severe via markets and free mobility. For example, Roland (2000) has shown how the existence of a managerial labour market due to the presence of the private sector can break the monopsony power of government towards managers and thus reduce the dependency of the latter on government. The literature on soft budget constraints (see Dewatripont *et al* 1998, Roland 2000) shows for example that entry and competition reduce the softness of budget constraints because they reduce the opportunity cost to government of not bailing out firms in terms of job losses and other costs of hard budget constraints. Also, the profit incentives in private firms can be stronger than rent-seeking incentives (and thus discourage the latter) when the profit opportunities are big enough. These are just a few examples. Much research still needs to be done to understand better the deeper reasons for inefficiencies in state-owned enterprises but the current literature goes beyond the simple dichotomy between private and state ownership and tries to understand the exact mechanisms by which private firms can be more efficient.

Problems with dispersed share ownership.

It is well known, at least since Grossman and Hart (1980) that dispersed share ownership is associated with a free rider problem in monitoring. Dispersed outside ownership has been an inherent feature of voucher privatization in transition economies. In the Czech Republic, individual citizens were given vouchers to buy shares of enterprises and no mechanism was put in place to encourage the emergence of strong blockholders. The Polish program for mass-privatization tried to avoid the dispersed share ownership of the Czech plan by having large investment funds hold shares in enterprises. However, here again, the issue of dispersed share ownership appeared at the level of ownership in the investment funds. Indeed, citizens were to be given vouchers to buy shares in the investment funds instead of shares in firms. There was thus dispersed ownership in investment funds.

It is important to note that the most perfect legal environment will not eliminate the free rider problem and thus will not lead to an improvement of management if firms have dispersed ownership. Perfecting the law can thus be misguided when dispersed ownership is an important issue, as is the case with mass-privatization. The law can of course still be useful in protecting the rights of minority shareholders from abuse by management. It should be noted that full concentration of assets by blockholders also has its costs since over-monitoring may stifle initiative by management (Burkart, Gromb, and Pannunzi 1997). Some mix of concentrated ownership and dispersed ownership trades off optimally the costs of free-riding with the costs of over-monitoring.

Problems with lack of minority Shareholder Protection

The issue of minority shareholder protection has become very important in the context of transition economies, especially in the Czech Republic and Russia where mass privatization programs were introduced. The concept of "tunnelling" has been coined in the Czech Republic to denote various methods by which management can engage in asset-stripping to the detriment of minority shareholder interests.

Mass-privatization tends to enhance the net benefit from asset-stripping. Since managers or owners have received the asset nearly from free, they can make an immense gain from asset-stripping, even when the latter would not be optimal from the economic point of view.

Obviously, the question is raised of why management would want to engage in asset-stripping in the first place. There are various possible reasons for this. First of all, the owners may not be the most competent. Therefore, even though another owner would prefer to restructure the firm, an incompetent owner may prefer to engage in asset-stripping. Second, if the general environment in the economy is very uncertain, then owners may prefer to reap the sure gains from asset-stripping rather than the uncertain benefits from investing to restructure. Such uncertainty can even be endogenous and lead to multiple equilibria. Managers who believe that there may be re-nationalisation or political instability may engage in asset-stripping thereby leading to reinforce political instability.

Owners who have bought the assets, on the other hand, will have less incentives to engage in asset-stripping because they will never, from an *ex ante* point of view, want to engage in actions that reduce the value of the assets below their purchase price. In other words, they will not be interested in purchasing firms whose value they could only reduce.

The detailed observation of various tunnelling techniques has sometimes let to the conclusion that improvements in existing laws could reduce tunnelling. Indeed, each technique of tunnelling is associated to a given loophole in the law. Therefore, it can be argued that fixing those loopholes will help reduce tunnelling. Good laws are certainly a necessary safeguard, but they are not a sufficient one. Even if the law is improved, how can one be sure that the law will be enforced, that insiders will not bribe regulators, etc? Russia, for example, has rather good laws. However, the enforcement of laws is rather low (see e.g. Berglöf and von Thadden 1999; Black, *et al* 2000).

Governance and access to outside funds

Control rights and their distribution change the incentives within the firms but access to outside funds is equally crucial to achieve efficiency. Usually, those who have control rights over the firm bring outside funds or have the capacity to bring outside funds (either internally accumulated or via access to debt and equity). With mass-privatization whether privatization to outsiders and insiders, this is not the case. There is de facto a decoupling of the transfer of ownership and of the financing of restructuring via the access to outside funds. Assets may have been transferred into private hands that do not have easy access to outside funds.

Access to outside funds will depend: 1) on the state of the financial system and its liquidity, 2) on whether the internal corporate governance arrangements in the firm convince investors to put money in the firm. From that perspective, outside investors may ask to be given control rights in exchange for access to funds. This should be seen as a positive development as such shift of control rights may correct the initial allocation of assets achieved via privatization. This will reduce the possible insider bias. However one must be careful not to draw generalizations from this case. As we will see later, one must fully recognize the heterogeneity of various situations one is facing. Not all firms need outside funds even in cases when outside control does not enhance efficiency nor will they necessarily relinquish control rights against outside funds.

Developing Corporate Governance in Transition Economies

Babic (2001) claims that there are two basic dilemmas connected with the corporate governance problem in transition economies. First, is it possible to have the identical framework that has evolved over centuries in developed market economies for the emerging markets, or is it better to adapt the system of corporate governance to the specific circumstances of a transition economy? The second dilemma involves the question of the appropriateness of the mechanism used for corporate governance. The existing corporate governance literature is almost exclusively concerned with external mechanisms - accounting transparency to improve the accuracy of stock market valuations, regulatory pursuit of fraud, the role of the shareholders' general meeting, "disciplinary" takeovers, legal requirements for the appointment of "external" directors, and so on (Monks and Minow 2003). In these external mechanisms the crucial role belongs to the well-developed stock market or to the monitoring role of the banks. Unfortunately, in transition economics these mechanisms of market discipline hardly work because of the lack of such institutions as a stock markets and an efficient banking sector.

At the same time, in the transition economies, the internal mechanisms- owners, board of directors and managers - differ significantly in comparison to the internal mechanisms of the developed market economies. First, the concept of ownership itself is problematic. Ownership of post-socialist enterprises was often shared between the state, public corporate bodies, banks, municipal bodies, managers, employees, other state or private companies, private individuals and foreign individuals and corporations. The absence of 'real owners' leads to neglect of the interests of capital itself and thus to degradation in the quality of the capital, damaging the long-term interests of the firm (Babic 2001). Second, the boards of directors fail to exercise a true monitoring role. Because the state is the key stockholder, there is a misbalance of power among the various stockholders. The members of the board of directors are usually the representatives of the state, the ruling party, public corporate bodies or even the banks. For individual board members the motivation to act is inhibited by their dependence on management for benefits such as lucrative appointments to boards of directors. Even if they have the motivation to exercise direct control over managers, they lack the knowledge to make managerial decisions. As a consequence, the role of the board of directors is reduced to financial control, which assumes maximization of the short-term results and evaluation of the managers' performance retroactively. Third, the upper "echelon" of managers acquired their knowledge and skills in a business environment which did not require the development of the skills of transformational or strategic leadership. So, transition countries have an archaic cadre of managers who do not posses a capacity for strategic thinking, vision creation, team work, risk taking and change management. Potentially new managers and leaders are facing a new challenge which comes from the Western countries in the form of ready-made solutions, but they are also facing a challenge to respond to specific requirements of the business environment encountered in particular countries. Another problem is related to the non-existence of a market for management talent and the difficulty of evaluating managers in an impartial manner.

2.5. Socially Responsible Restructuring

We have noticed from the discussions in the previous sections that wherever enterprise restructuring is taking place, it entails significant labour and social costs. During restructuring there is often significant downsizing of labour, which has the social impact on stakeholders who might be influenced by restructuring. Thus, reaction can be such that restructuring is slowed and in some cases stalled. This fact is increasingly recognized by development agencies, governments, and enterprise management and as a result how restructuring is implemented in a socially responsible way is becoming an integral part of the design of restructuring programs.

Experience of the major restructuring operations carried out in Europe in the steel, coal and shipbuilding industries has shown that successful restructuring can be better achieved through joint efforts involving the public authorities, companies and employees' representatives. This process should seek to safeguard employees' rights and enable them to undergo vocational retraining where necessary, to modernise production tools and processes in order to develop on-site activities, to mobilise public and private financing and to establish procedures for information, dialogue, cooperation and partnership. Companies should take up their share of responsibility to ensure the employability of their staff.

2.5.1. Concept and Definition

The concept of socially responsible restructuring (SRR) was emerging just in recent years in the documents of international organizations. It is relative vague concept, and there has been little success in the academic literature in making it sufficiently concrete and operational in management term, although increasingly more studies have been undertaken in this field (Fretwell 2004; Burke and Nelson 1997; Luss and Nyce

2002; Smeltzer and Zener 1994; Clark and Soulsby 1998; Cascio 2002b and 2003; Band and Tustin 1995; Lei and Hitt 1995; Champlin 1998; Karake 1998; Carroll 1984).

Wayne F. Cascio, professor of management at the University of Colorado-Denver, is one of the first to present systematic longitudinal research on the effects of downsizing, particularly, initiated the concept of *Responsible Restructuring.* While writing *the U. S. Department of Labour's 1995 publication Guide to Responsible Restructuring*, and 2002 book "*Responsible Restructuring: Creative and Profitable Alternatives to Layoffs*□ he draws on the results of an 18-year study of S&P 500 firms to prove that it makes good business sense to restructure responsibly - to avoid downsizing and instead regard employees as assets to be developed rather than costs to be cut. Cascio explodes 13 common myths about downsizing, detailing its negative impact on profitability, productivity, quality, and on the morale, commitment, and even health of survivors. He uses real-life examples to illustrate successful approaches to responsible restructuring used by companies such as Charles Schwab, Compaq, Cisco, Motorola, Reflexite, and Southwest Airlines. And he offers specific, step-by-step advice on what to do-and what not to do-when developing and implementing a restructuring strategy.

He claims that responsible restructuring relies on workers to provide substantial competitive advantage by adapting a wide range of practices such as training, information sharing, participatory management, flattened organizational structures, labour management partnerships, compensation linked to skills, and customer satisfaction.

Cascio (2002a and 2003) provides strategies for socially responsible restructuring and highlighted some things not to do. For example, build a plan for restructuring into the overall economic plan for firm's business; carefully consider the rationale behind restructuring; before making any final decisions about restructuring, managers should make their concerns known to employees and seek their input; don't use downsizing as a "quick fix" to achieve short-term goals in the face of long-term problems. Consider other alternatives first, and ensure that management at all levels shares the pain and participates in any sacrifices employees are asked to bear; if layoffs are necessary, be sure that the process of selecting excess positions is perceived as fair and that decisions are made in a consistent manner. Make special efforts to retain the best and the brightest, and provide maximum advance notice to terminated employees; communicate regularly and in a variety of ways to keep everyone abreast of new developments and information; give survivors a reason to stay and prospective new hires a reason to join; Train employees and their managers in the new ways of operating. Restructuring means change, and employees at all levels need help in coping with changes in areas such as reporting relationships, new organizational arrangements, and reengineered business processes. Evidence indicates clearly that firms whose training budgets increase following a restructuring are more likely to realize improved productivity, profits, and quality; and examine carefully human resource (HR) systems in light of the change of strategy or environment facing the firm. Training employees in the new ways of operating is important, but so also are other HR systems. These include workforce planning, based on changes in business strategy, markets, customers, and expected economic conditions; recruitment and selection, based on the need to change both the number and skills mix of new hires; performance appraisal, based on changes in the work to be done; compensation, based on changes in skills requirements or responsibilities; and labour relations, based on the need to involve employees and their unions in the restructuring process.

Luss and Nyce (2002) drew data from a 1993 Watson Wyatt survey on Best Practices in Corporate Restructuring, and analyzed how the successful restructured companies in the United States, Canada and the United Kingdom over the previous two years. The study shows that successful restructures managed to cut costs in short-run while positioning themselves to significantly outperform their industry peers in the long run. They enjoyed significantly higher total returns to shareholders over the next five years than any of the other groups they examined. In their research, they identified the successful restructuring with downsizing as those communicate effectively, get employees involved, use training targeted to skills needed in restructuring, mobilize managers to support the effort, reduce the workforce only once, select workers carefully to minimize those replaced, pay particular attention to recovery actions and place a greater emphasis on improved cash flows and debt reduction. In a sense, it is socially responsible restructuring behaviour.

International Labour Organization (ILO) is always concerned about impact of restructuring/downsizing on workers and employees. Over the past years, ILO has carried out series of studies on enterprise restructuring based on enterprise surveys conducted in transition economies. The studies have produced a number of country reports which investigate the change in labour demands, employment impact of privatization and restructuring, human resource development, and in particular, socially responsible policies during transition to a market-oriented economy (Evans-Klock and Samorodov 1998; ILO 1997, 1999a; 1999b; 1999c and 2000; Marcovitch 1999). ILO developed the concept of a hierarchy of restructuring and advocates that higher more strategic, level of restructuring be studied carefully before decisions are taken to downsize or reduce personnel costs. These higher levels include revitalization and change in strategy, ownership, financial structures, organization, production, outsourcing and non-personnel cost reduction. The result of ILO studies reveals that the higher the category and the more strategic the approach, the greater the sustainable impact on shareholder value and the less the impact on employees and other stakeholders. Thus, companies should focus their attention initially on the "upstream" approaches and practice continuous "rightsizing" rather than hurriedly initiating a major one-off downsizing programme. ILO defines the socially responsible company as the one which rewards shareholders with a reasonable return over time; is customer focused; considers employees as its most important asset, provides meaningful work, fair wages and benefits, ensures their employability, and provides an enabling work environment; contributes to the prosperity and social cohesion of the communities in which it operates; applies the golden rule ("do unto others as you would have them do unto you") to its business partners (suppliers, alliances, franchisees, etc.); and practices eco-efficiency and environmental sustainability. The concept of the socially responsible restructuring is defined as using one or more approaches to consciously take into consideration of all the interests of all stakeholders. In practice, the process is often as important as the substance of change to the success of restructuring. This means respecting the values of the enterprise, seeking the involvement of those affected, practicing open communications and treating all employees with respect and dignity. The emphasis must be on overall "stakeholder value" rather than short-term shareholder gains.

In recent years, the widespread restructuring taking place in Europe raises concerns for all of the employees and other stakeholders as the closure of a factory or a heavy cut in its workforce may involve a serious economic, social or political crisis in a community. Few companies escape the need to restructure, often through downsizing, with the year 2000 seeing more mergers and acquisitions than any other year in history. More recently in March 2000, the European Council in Lisbon made a special appeal to companies' sense of social responsibility regarding best practices for lifelong learning, work organisation, equal opportunities, social inclusion and sustainable development. In the summer of 2001, the European Commission published a Green Paper launching a broad consultation on the European approach to corporate social responsibility. It requires both public authorities and business to show a new sense of both social and environmental responsibility. The companies should rethink their roles and responsibilities not only in relation to their shareholders but also to the needs and expectations of all their stakeholders. Adopting measures that limit the negative impact of activities on the environment is no longer enough, the focus has broadened to also include the dimension referred to as CSR.

In the Green Paper of (Commission of the European Communities 2001), SRR is defined as the restructuring that can balance and take into consideration the interests and concerns of all those who are affected by the changes and decisions, which involves seeking the participation and involvement of those affected through open information and consultation. Furthermore, restructuring shall be well prepared by identifying major risks, calculating all the costs and evaluating all of the alternatives which would reduce the need for redundancies.

This definition emphasizes strategies and communication tactics before restructuring happens, involvement of stakeholders and alternative approaches in the process of restructuring, and as well the support and social service after restructuring. Other researchers simply regard restructuring with labour shedding and downsizing as the socially irresponsible restructuring, and strategic restructuring with innovative products and service, and retaining human capital as responsible restructuring (Domadenik and Vehovec 2002; Grosfeld and Roland 1997).

As I described in Section 2.3, when Grosfeld and Roland (1997) studied the restructuring and firm performance in transition economies, they divided the restructuring into two types: defensive and strategic restructuring. Defensive restructuring essentially means taking measures that seek to reduce costs and scale down enterprise activity. This includes cutting obsolete production lines, shedding labour and getting rid of non-productive assets. Strategic restructuring is based on a thoughtful business strategy developed in response to a need for a profound redeployment of assets. It implies the introduction of new product lines, new processes, new technologies and new investments. Judging from the definition, I can term these two types of restructurings as the socially irresponsible and socially responsible restructuring.

Grosfeld and Roland (1997) also analyzed the existing evidence on enterprise restructuring in the Czech Republic, Hungary and Poland by distinguishing the two types of restructuring, and concluded that there had been significant restructuring activities across the board in all countries under review, despite the differences in national policies. However, it appears that the adjustment measures have mainly had a defensive character, the extent of strategic restructuring being much more limited. He argued that more profound strategic restructuring requires effective corporate governance which depends upon both changes in the ownership structure and reform of the financial system.

On the base of Grosfeld and Roland's (1997) study, Domadenik and Vehovec (2002) developed a theoretical framework and provide empirical estimates of the extent of several forms of restructuring in 130 privatized firms in a model transition economy (Slovenia) during the period of 1996-1998. In view of the institutional developments in the transition economies, they also divided restructuring into defensive (related to short-term cutting costs) and strategic (focused on increasing revenues through investment). Using predictions from the theoretical framework, they estimated a firm-level labour demand equation to test defensive restructuring and an augmented investment equation to assess strategic restructuring. The labour demand estimates point to relatively slow defensive restructuring, while the investment model estimates indicate the presence of credit rationing and bargaining in most types of soft investment. The research didn't find support for the hypothesis that firms treat expenditures on employee training as investment, but there was evidence that they behave similarly as those from developed countries in that they display features of profit maximizing behaviour.

The World Bank has been concerned about the consequences and impact of restructuring and privatization on different stakeholders. The importance the World Bank attaches to socially responsible practices is reflected in its increased lending to support public enterprise restructuring in recent years. Since 1987, 88 Bank operations in 47 countries have contained significant levels of assistance to workers made redundant because of enterprise restructuring or privatization. The sums involved for such lending more than doubled from 1994 to 1998 (Chen 2001). The World Bank has learned that good macroeconomic policies—combined with relevant social policies - provide a favourable environment for sustained economic growth and poverty reduction.

Two main reasons explain why the Bank is paying more attention to lay-offs. The first is the Bank's primary objective in poverty reduction. Lay-offs have been referred to as the transient poor (Subbarao and Braithwaite 1995). Most transient poor people have the potential to recover income losses and not join the ranks of the long-term unemployed if appropriate support in the form of cost-effective labour programs is provided. The second reason is the Bank's increasing emphasis on social stability as a prerequisite for long-term economic growth. Evidence shows that most lay-offs are politically vocal, and strong labour resistances to downsizing can slow down the reform process. For instance, the social unrest prompted by the recent Asian economic crisis has led international organizations to pay a great deal of attention to social sector development. This raises the question of how to ensure long-term economic stability and minimize labour losses.

The major labour assistance programs the World Bank has provided are shown in Table 2-1. We found that the most common components of World Bank public enterprise and privatization labour assistance projects is training and retraining (18%), followed by labour market mobility and information development (11.5%), and the provision of severance pay (11%).

Table 2- 1 Labour Assistance Components to Redundant Workers, 1987-1998

Component	*Number*	*Percentage*
Training/retraining	35	17.5
Labour market mobility/ job information development	23	11.5
Severance pay	22	11.0
Employment service/counselling	20	10.0
Labour adjustment & labour redundancy program design	19	9.5
Unemployed insurance/ living allowance	14	7.0
Overall social safety net assistance	13	6.5

Pension/income support	12	6.0
Job creation (public work & private sector development)	11	5.5
Small business assistance	9	4.5
Voluntary departure schemes	6	3.0
Earlier retirement	6	3.0
Shareholding through asset transfer & employee participation	5	2.5
Revision of labour contract and labour law	5	2.5
Total	200	100.0

Source: Chen, Yi (2001), 揟he World Bank and the Provision of Assistance to Redundant Workers: Experience with Enterprise Restructuring and Future Directions? Social Protection Discussion Paper Series, No. 0112, P17.

The studies undertaken by the World Bank on transition economies have identified the strategies and policies at different stages of restructuring based on the experience of transition economies which underwent a large scale of restructuring and privatization (Dar and Tzannatos 1999; Betcherman, Olivas, and Dar 2004; Fretwell 2004). For example, when the restructuring with downsizing and lay-offs is carried out, the main stakeholders that may be affected by or influence the design, implementation and outcomes of restructuring and privatization, should be identified. The labour adjustment plans for workers prior to dismissal should be developed in order to help "assist and push" displaced workers back into the productive employment; and temporary income support and labour redeployment services to individual displaced workers and support regional development efforts. The communications strategy should support and continuously be shaped by consultants with stakeholders on the labour restructuring strategy and financial/social packages to be extended to redundant workers. In addition, evaluation and monitoring of activities need to be built in as an integral part of any social mitigation activity related to privatization and restructuring. In undertaking evaluations, the social, political and economic objectives of the programs need to be taken into account.

2.5.2. Socially Responsible Restructuring and Downsizing

Three types of organizational transition have received increasing attention during the past few years: mergers and acquisitions, downsizing and privatization. These newly emerging sources of organizational change share some common features.

They are interrelated since all represent the effects of the economic recession and attempts by organizations to survive and to increase productivity (Burke and Nelson 1997).

Downsizing can be and often is an opportunity to reduce costs, improve competitiveness and reinvigorate an organization if it is managed responsibly. However, it can also strip an organization of valuable human assets and lead to deteriorating productivity, morale and loyalty.

Downsizing has a very negative connotation arising from the perception that it means having fewer people do more work; the idea of increasing job demands is a major source of stress in the workplace. As a result, company announcements more often refer to collective layoffs as restructuring, rationalization or resizing. It is important to recognize that downsizing may well be essential for a company to survive or remain competitive.

The real question is how downsizing is done, rather than whether to downsize. Companies that downsize through buy-outs and attrition, that help their workers get new jobs, and that provides outplacement services, end up much better positioned than companies, which simply wield the axe. They have a better chance of retaining the loyalty of the surviving workers. Trust is one of the most valuable yet brittle assets in any enterprise. So over the long term, it's far better for companies to downsize in a humane way" (Reich, 1996).

Two schools of thought debate on issue of social responsibility and downsizing. One school, embraced by advocates of the social responsibility movement, argues that layoffs have devastated the industrial workforce, leaving workers with little hope for job security and improving economic prospects. Underlying this pro-social responsibility view is the belief that legal solutions are not always sufficient. The time-lag problem is suggested to be at the heart of this argument in that the law is "primarily a reactive institution," (Stone 1975). This means that there may exist a significant period of time between when a problem is recognized and when the legislature can pass a law to solve the problem. Until new laws are passed "a great deal of damage- some irreversible - can be done" (Stone 1974). According to Drucker (1993), organizations have to take on "social responsibility". There is no one else around in the society of organizations to take care of society itself. Yet organizations must do so responsibly, within the limits of their competence, and without endangering their performance capacity.

Another school suggests that American companies, pressured by global competition, increased quality of foreign products, and the emergence of new economic alliances among former rivals, have no choice but to restructuring their firms either through downsizing, downscoping, or retrenchment. Social responsibility for proponents of this school represents a commitment not to waste the resources of the society at large in unprofitable plants and lines of businesses. To those, adopting new management strategies or using new technologies in order to produce more for less, would increase their stockholders' wealth. This improvement of stockholders' wealth is assumed to have a trickle over effect on other stakeholders. In terms of goods and services, and even increased rate of job creation in the no-so- distant future.

Is downsizing an indication of a social responsible behaviour? Is it an indication of socially irresponsible behaviour? How is company's reputations affected by downsizing Does the degree of downsizing affect the social perception of corporations? A number of the researchers have attempted to estimate the effect of restructuring and downsizing on firm performance in specific countries. Karake (1998) empirically test the relationship between a company's social responsibility performance as measured by the company's reputation index and the degree of downsizing of employees. His research supports the hypothesis that as companies eliminate jobs and layoff workers, they are perceived as being less reputable, hence, less socially responsible, and as well support the previous research which revealed a positive association between a company's social performance, as measured by a company's reputation index, and its financial performance as measured by its return on equity.

Cascio (1993, 2002c, 2003) studied the effects of extreme downsizing on the financial performance of 25 large firms in United States over a 7-year period. Cascio and his colleagues (2000) examined financial and employment data from companies in the Standard & Poor's 500 with a view to examine the relationships between changes in employment and financial performance. They assigned companies into one of seven mutually exclusive categories based upon their level of change in employment and their level of change in plant and equipment, or assets. Categories included pure Employment Downsizers, Asset Downsizers, Combination Downsizers, similar categories of upsizers, and Stable Employers. They then observed the firms' financial performance (profitability and total return on common stock) from one year before to two years after the employment-change events. They examined results for firms in each category on an independent as well as on an industry-adjusted basis. In our most recent study, we observed a total of 6,418 occurrences of changes in employment for S&P 500 companies during the 18-year period from 1982 through 2000. As in their earlier studies, they found no significant, consistent evidence that employment downsizing led to improved financial performance, as measured by return on assets or industry-adjusted return on assets. Downsizing strategies, either employment downsizing or asset downsizing, did not yield long-term payoffs that were significantly larger than those generated by Stable Employers-that is, those companies in which the complement of employees did not fluctuate by more than + - 5 per cent.

Cascio's study showcases a few of the many approaches which companies have taken to avoid involuntary layoffs and to restructure responsibly some reaping great benefits for their efforts. He also suggested some of guidelines for how to begin responsible restructuring to produce competitive companies and committed workers. The results of study suggest companies did not realize cost efficiencies to the extent they may have expected prior to making dramatic reductions in levels of employees. There is no evidence to indicate that downsizing employees was the sole step the 25 organizations in question took to become more efficient and productive. However, the magnitude of the cuts in employment indicates that it was a major initiative in each of the firms. Using real-life illustrations of successful, responsible restructurings at companies such as Charles Schwab, Cisco, Motorola, and Intel, Cascio examines the specific practices these leading firms use instead of layoffs - including retraining, labour-management partnership, and compensation linked to organizational performance. These practices demonstrate that these companies view their workers as assets to be developed rather than as costs to be cut. Cascio presents compelling evidence showing that businesses adopting these measures fare better than businesses in similar circumstances that choose downsizing.

Karake (1998) examined empirically the relationship between a company's socially responsible performance as measured by the company's reputation index, and the degree of downsizing of employees and a company's discriminatory practices by using 178 sampled large publicly-held US-based corporations which announced their intentions to downsize during the 1990-1992 period. The statistical analysis does support the hypothesis that as companies eliminate jobs and layoff workers, they are perceived as being less reputable, hence, less socially responsible. The analysis further supported previous research which revealed a positive association between a company's social performance, as measured by a company's reputation index, and its financial performance, as measured by return on equity. Karake (1997) also developed relative index for downsizing employees to measure firm performance based on the problems survivors' experience. The underlying principle of the model is that by addressing the issues that have been observed as survivor syndrome prior to the downsizing, the negative outcomes on survivors will be minimized. As with the realistic job preview (RJP) (Wanous 1973), the key is to present information prior to the event as if trying to vaccinate or immunize employees to the ensuing downsizing. On the basis of Wanous's Model of RJP, Appelbaum (2000) developed the Realistic Downsizing Preview (RDP) model, which can be effectively used before the downsizing. RDP is implemented to prevent survivor syndrome in the aftermath of the downsizing. Appelbuam argues that the foundation of RDP model is that by addressing issues that have been observed as survivor syndromes prior to a downsizing, the negative outcomes can be minimized.

2.5.3. Socially Responsible Restructuring and Corporate Governance

Corporate restructuring and improved corporate governance are essential parts of economic reform programs under way in many countries. Thus, many studies attempt to examine how corporations can be restructured to promote growth and reduce excessive debt without placing undue burdens on taxpayers, and what framework is needed to promote better corporate governance.

Corporate restructuring involves restructuring the assets and liabilities of corporations, including their debt-to-equity structures, in line with their cash-flow needs to promote efficiency, restore growth, and minimize the cost to taxpayers. Corporate governance refers to the framework of rules and regulations that enable the stakeholders to exercise appropriate oversight of a company to maximize its value and to obtain a return on their holdings (Iskander *et al* 1999). Both corporate and financial sector restructuring are central to ongoing economic reform programs in emerging markets and transition economies. Thompson and Wright (1995) argue that the corporate restructuring transaction is regarded as an innovation in corporate governance; it can remedy the perceived agency problems associated with management control.

In the current debate on governance issues there is a widely articulated view (Charkham 1994) that the Anglo-American style capital market, with its emphasis on liquidity and the separation of institutional shareholders from the firms they invest in often results in poor managerial accountability and substantial departures from shareholder value maximization. It is further suggested that neither of the principal market restraints on managerial behaviour - i.e. the managerial labour market and the corporate acquisitions market - is particularly effective. The former, which might be expected to reward success and penalize failure Fama (1980) shows, at best, a very weak average relationship between top executive remuneration and performance; whilst the market for corporate control hypothesis is flawed if managers can deploy effective costly defences, including size, or if errant managers use their discretion to pursue takeover targets. The corporate restructuring transaction may be considered as an organic response of Anglo-American capital markets to the governance problems encountered therein. The description of 'corporate restructuring transaction' is used to embrace a range of organizational developments -leveraged buy-outs, management buy-outs and buy-ins, leveraged recapitalizations and cash-outs, employee stock ownership plans etc. - which involve simultaneous changes in the ownership, financial structure and incentive systems of firms. Changes which typically have the effect of securing: first, a substantial re-unification of share ownership and manager control; second, the partial substitution of various debt instruments for equity in the firm's financial structure; third, the introduction of increased incentives for investors and/or lenders to monitor senior managers; and fourth, the introduction of greater incentives at the peak tier of the managerial hierarchy and often at subordinate levels as well. Restructuring transactions are here distinguished from traditional acquisitions, although it is recognized that the underlying motivation may be similar. They are also distinguished from certain other recent phenomena affecting the corporate sector, especially voluntary divestment (including 'refocusing') and so-called 'downsizing' although it is clear that these and other retrenchment activities may be strongly associated with restructuring organizational forms (Liebeskind, *et al* 1992).

Two key sets of institutions that influence restructuring are those in the field of corporate governance, especially the way that firms are financed and owned, and those in the area of industrial relations, particularly the way that managements are required to consult and negotiate with their workforces. Important differences in the nature of institutions in these two spheres shape the way that firms undertake restructuring (Edwards 2004). Dutz and Vagliasindi (1999) identify four main channels through which effective corporate governance can affect restructuring: (1). by identifying appropriate restructuring/turnaround agents; (2) by ensuring managers take appropriate restructuring decisions; (3) by attracting and retaining external finance needed for restructuring; (4) by facilitating a broader social and political legitimacy for the restructuring process.

Filatotchev, *et al* (2003) examine corporate governance in a situation where managerial ownership is dominant and to examine the tradeoffs (costs) of such ownership relative to the benefits. They go beyond the traditional governance-strategy-performance framework by considering organizational capabilities as substitutes for managerial ownership. Accordingly, they link agency and learning theories through an integrated model on the effects of governance and organizational capabilities on corporate restructuring. Their analysis, therefore, considers the organizational level implications for restructuring of the differing corporate governance and learning associated with different forms of privatization, and provides a link between firm-level developments with systemic, national level privatization outcomes that applies across all firms.

As I stated in the preceding sections, national corporate governance regimes differ along a variety of dimensions: ownership, finance, corporate law, boardroom practices, management pay, and the role of employees. One of the most important and controversial differences relates to markets for corporate control. In countries such as Britain or the United States, markets for corporate control are thought to perform important governance functions in promoting a greater shareholder orientation among corporate management. By contrast, Germany is often described as having a bank-oriented, blockholder, or stakeholder model. Markets for corporate control have not played a significant role in the post-war period.

A large literature now illustrates important linkages between finance, management, and industrial relations. As I described previously, most comparisons contrast two types of corporate governance systems, such as shareholder vs. stakeholder or outsider vs. insider systems. These models reflect strong negative correlations between national capital market development (e.g. shareholder rights, market capitalization, ownership dispersion, or merger and acquisition activity), on the one hand, and industrial relations (e.g. co-ordination of wage bargaining and employment protection law) or employment (e.g. employee turnover) on the other (Höpner 2005).

It is argued that two key aspects of national business systems, which influence nature of restructuring, are the systems of corporate governance and industrial relations. As I described in the previous section, systems of corporate governance are divided into 'insider (stakeholder)' and 'outsider (stockholder)' models. In the former, ownership is concentrated among a small number of shareholders, and owner-management relations are stable and close. Owners use this proximity to assess a range of 'organizational competencies' as their basis for predicting future performance. It is often argued that the stability of ownership in firms in these systems and the criteria used to assess firm performance allow managers to respond to changed market conditions in a measured, gradual manner and, hence, firms tend to restructure incrementally in the main (Hall and Soskice 2001). The ownership patterns and tendency towards incremental restructuring are compatible with an industrial relations system that allows employee 'voices' to be heard, through statutory rights for employees to be represented on company boards and works councils as is the case in Germany, or through the negotiation of a 'social plan' to deal with the consequences of restructuring for employees as is required in France. In outsider systems, of which the UK and Ireland are examples, ownership is widely dispersed across a large number of shareholders each of which holds only a small proportion of the total equity. Shareholders have fluid and distant relations with managers and current financial performance is used as the primary indicator of the health of the firm. The need to convince shareholders lacking detailed inside knowledge of firms that market challenges are being confronted leads managers in this context to undertake more rapid and radical restructuring (Hall and Soskice 2001).This preoccupation with the interests of distant, and some argue fickle, shareholders makes firms in outsider systems reluctant to engage in consultation and negotiation of their restructuring plans with employee representatives. Thus, outsider systems mesh neatly with deregulated labour markets, where employees have relatively little scope to exercise 'voice'.

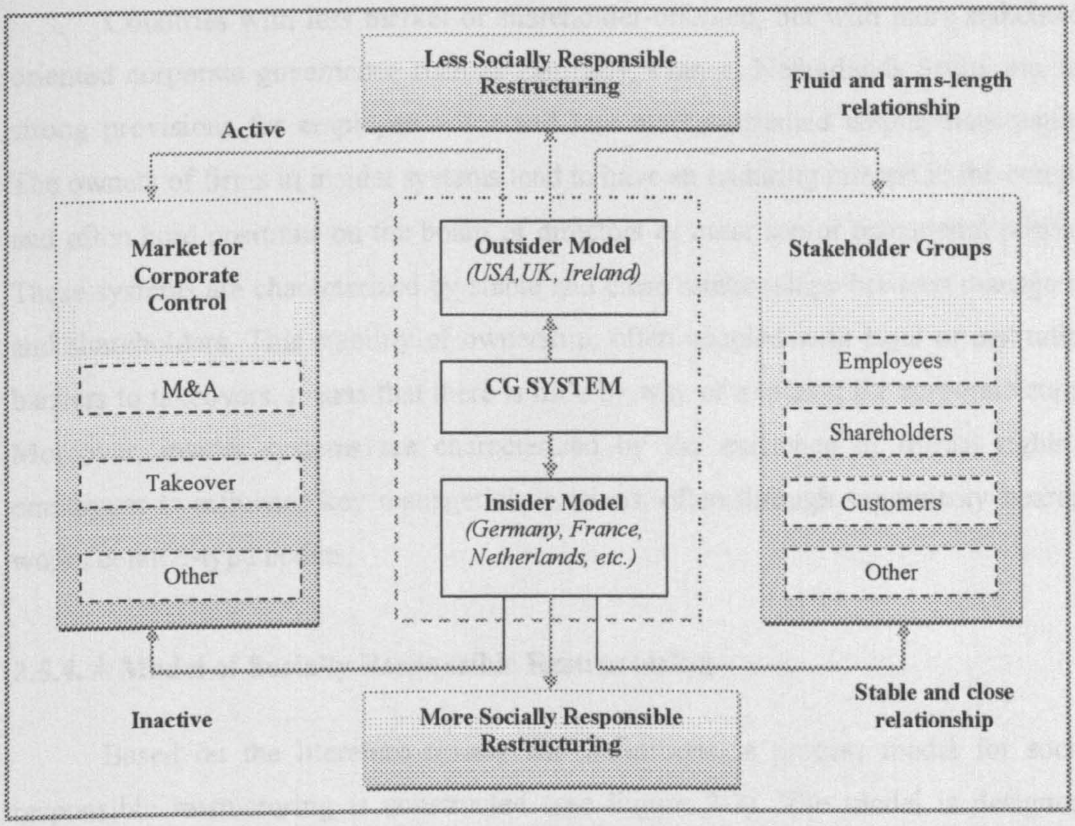
The extent of socially responsible performance in restructuring might be influenced by the different systems of corporate governance. The comparative research undertaken by EIRO (2002) shows that there are two principal channels through which employees can influence restructuring. The first is by using those rights that are based on systems of co-determination or social concentration. Some national systems of employee representation grant employees the right to be informed well in advance of any restructuring that will have a significant impact on employment, and allow their representatives to negotiate a 'social plan' to deal with the consequences. This is the case in Austria, Belgium and Germany. Many countries in Europe have rights concerning employee representation on company's supervisory or management boards, or boards of directors, which have the ability to discuss and decide on proposed cases of restructuring. This is the case in Sweden, Austria, Germany, the Netherlands, Denmark, Finland, Luxembourg and Norway. To varying degrees, and in various forms, these countries have systems of co-determination that are part of a tradition of dialogue and that promote a spirit of compromise when it comes to the extent and nature of restructuring. Employee representatives are commonly drawn from trade unions, which can also be influential through collective bargaining in these systems, of course. Indeed, the position of unions is in most cases strengthened by the institutions of co-determination.

The second type of system is where the source of employee influence over restructuring is primarily through trade unions and collective bargaining. In some countries, this channel is the primary way in which employees are able to exert pressure on management, despite the existence of works councils. This is the case in France, Italy, Spain, Portugal and Greece. In the remaining, two countries, the UK and Ireland, which lack formal institutions such as works councils and do not have a strong tradition of social partnership, the influence of employees is largely dependent on the strength of unions at firm level. These two countries have a fairly minimalist legal framework, with the legal rights that employees enjoy coming mainly from EU Directives on collective redundancies or the transfer of undertakings (however, these rights may be increased to some extent by the implementation of the recent EU Directive on national information and consultation, which includes rights relating to restructuring plans). In countries where employee influence is principally through unions and collective bargaining, management-employee relations over how restructuring is dealt with tend to be more adversarial, and the ability of employees to influence restructuring varies considerably from sector to sector and firm to firm according to union strength.

Figure 2-1 shows how different systems of corporate governance influence the degree of socially responsible performance in restructuring. From the perspective of stakeholder theory, the extent to which the socially responsible performance depends on the extent of market for corporate control. Countries with more market- or shareholder-oriented corporate governance such as the U.S. and UK have weaker provisions for employee voice and more market-oriented employment patterns (Gospel and Pendleton 2004). The owners of firms tend to have a transitory interest in the firm and do not have close relationships with those in senior managerial positions within the company. The relationships between management and shareholders are fluid and arms-length. This system is characterized by the existence of an active 'market for corporate control'- takeovers, particularly hostile ones, are seen as both a remedy for managerial failure and a disciplinary mechanism on managers, ensuring that they act in the best interests of shareholders. Indeed, a further feature of this system in the primacy of shareholder rights over those of other organizational groups (particularly employees).

Meanwhile, countries outside the Anglo-Saxon world remain institutionally more diverse. Although corporate governance tends to be less market-oriented, some countries still have market-oriented characteristics. Likewise, employment tends to be more regulated, but patterns of unionization or employee participation still differ widely. The diverse patterns among this group make it difficult to disentangle how different corporate governance characteristics are specifically related to industrial relations (Jackson 2004).

Figure 2- 1 Socially Responsible Restructuring and CG Systems



Several interrelated arguments can be identified. First, codetermination is often related to concentrated ownership. Mark Roe argues that only concentrated owners can act as an effective counter-weight to employee representatives, since dispersed owners cannot easily exercise control rights (Roe 2003). Another related but inverse logic is that the demand for industrial democracy by employees was a response to concentrated ownership, since owners constituted an identifiable group whose authority should be limited. Second, strong bank-firm relationships may lead to more patients or socialized forms of corporate finance and control that are amenable to wider stake-holder participation (Hall and Soskice 2001). Third, legal rights for shareholders and legal rights for employees may be inversely related (Pagano and Volpin 2005a; Pagano and Volpin 2005b). For example, historical codifications of the nature of the corporation as a purely private association for shareholders may preclude conceptions of employee participation in the corporation (Donnelly *et al* 2001). Fourth, active capital markets may limit the scope or effectiveness of employee participation. For example, hostile takeovers may lead to breaches of trust with existing stakeholders and thus undermine the credibility of long-term commitments.

Countries with less market or shareholder-oriented, but with more stakeholder-oriented corporate governance such as Germany, France, Netherlands Spain, etc. have strong provisions for employee voice and less market-oriented employment patterns. The owners of firms in insider systems tend to have an enduring interest in the company and often hold positions on the board of directors or other senior managerial positions. These systems are characterized by stable and close relationships between management and shareholders. This stability of ownership, often coupled with legal or institutional barriers to takeovers, means that there is little by way of a market for corporate control. Moreover, insider systems are characterized by the existence of formal rights for employees to influence key managerial decisions, often through supervisory boards or works council-type bodies.

2.5.4. A Model of Socially Responsible Restructuring

Based on the literature review and definitions, a process model for socially responsible restructuring is constructed (see Figure 2-2). The model is designed to examine the socially responsible performance in restructuring. The model shows that four elements shall be incorporated in the process of socially responsible restructuring.

Enterprise analysis: Before the restructuring is undertaken, a firm should identify all stakeholders who may be infected by or influence the design, implementation and outcomes of restructuring. The main stakeholders include employees, workers' representatives, local community, government (national, regional, local), non-governmental organizations (NGOs), to develop a consistent communication strategy for restructuring based on stakeholder analysis.

An analysis of local labour markets is also need to be conducted to determine the capacity of local labour markets to absorb workers made redundant, and ability of public employment services (PES) and other agencies to mitigate the impact of group redundancies.

Staff reduction procedures and contractual obligations towards employees need to be determined to identify external and internal labour regulations that affect downsizing, layoffs, and determine statutory wage costs and other contractual obligations towards employees.

Financing plan for pre-layoff services package should be developed, an activity to determine funds available, including enterprise own funds (including investor financing), revenues from privatization, PES funds, budgetary support, borrowed funds, outside donor support, trade unions funds, etc., and to develop an estimate of take-up and cost for each type of program. Administrative structure for a labour redeployment programme (LRP) should be determined.

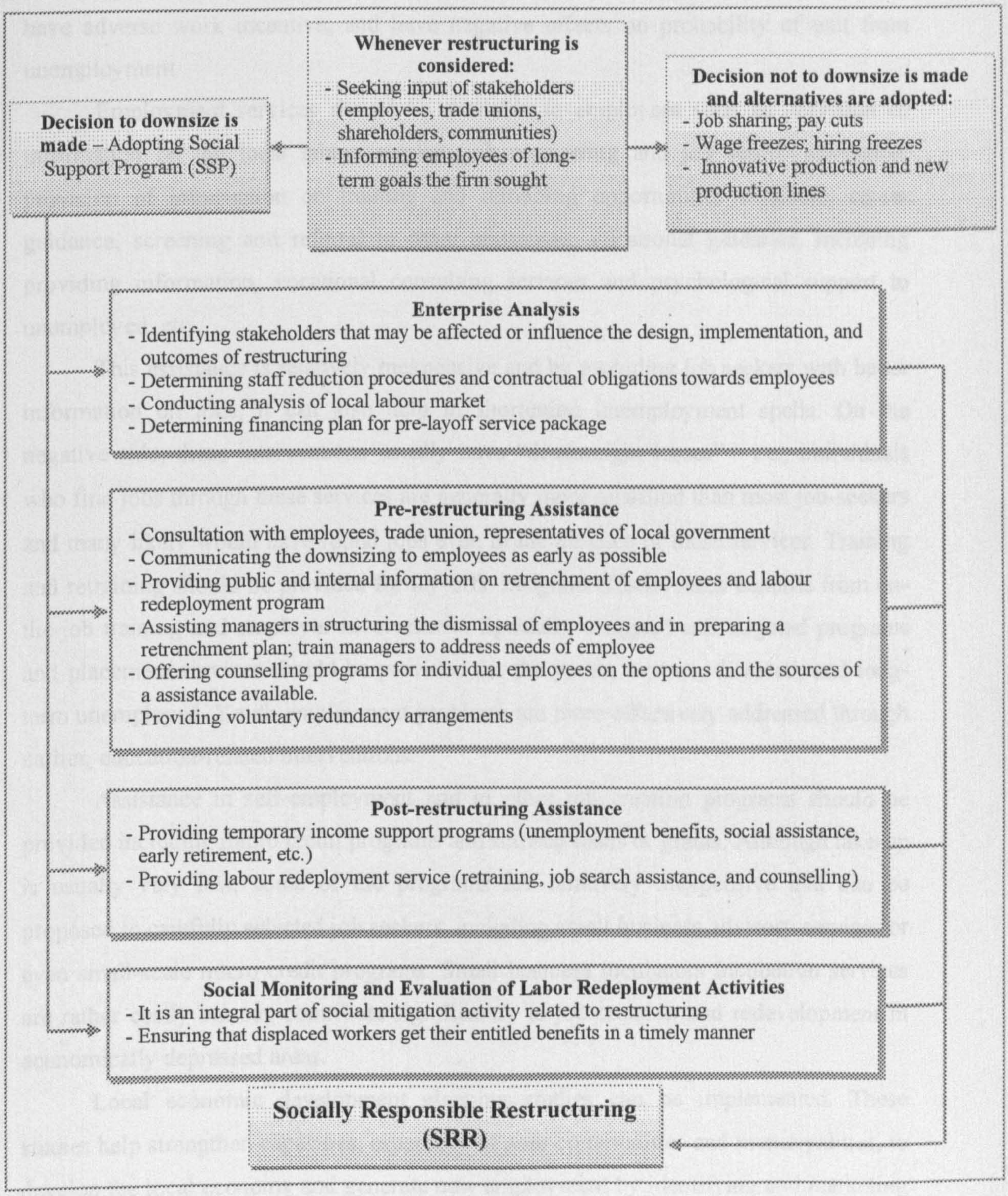
***Pre-restructuring assistance*:** Consultation should be conducted with employees, trade union, representatives of local government and employment services. Thus, it can provide the parties involved, as early as possible, an opportunity for consultation on measures to be taken to avert or to minimize the impact of downsizing and lay-off on the workers concerned. Public and internal information on retrenchment and labour redeployment program should be open to employees. This is an essential foundation for effective labour redeployment and employment services.

Early communication and consultation with workers is important to ensure fairness and transparency of the process. Assistance to management should be provided in structuring the dismissal of employees and in preparing a retrenchment plans; training for management on redundancy criteria. This provides management with personnel tools to do their job effectively, including policies on a formalized system of performance evaluation, and provides support to operational unit heads by developing a formal communication strategy on restructuring.

Counselling programs should be provided for individual employees on the options and the sources of assistance available; the legal rights of employees; provision of information on training and retraining opportunities available; career guidance, job search, screening and referral to other redeployment assistance; individual coaching and advising; workshops to teach job search skills; health assessment, counselling and referral of persons with diminished work capacity, etc. This can examine how to increase employability of redundant workers and introduce them to the type of measures they can use to find a new job.

Voluntary redundancy arrangements (prior to final dismissal) should be made including voluntary departure schemes, early retirement schemes and compensation payments on redundancy. These arrangements and benefits can reduce workers' resistance to restructuring and facilitate transition.

Figure 2- 2 Model of Socially Responsible Restructuring



Post-restructuring assistance. Temporary income support programs should be provided including unemployment benefits, unemployment assistance, social assistance, early retirement schemes for registered unemployed at pre-retirement age. These programs have income and consumption-smoothing impact and provide resources to conduct a job search. If the benefits were too generous and of long duration, they may have adverse work incentive, and have negative effects on probability of exit from unemployment

Employment services should be available to employees such as provision of information on the local labour market; job counseling and job search assistance; provision of information on training and retraining opportunities available; career guidance, screening and referral to other assistance; vocational guidance, including providing information, vocational consulting services and psychological support to unemployed, etc..

This assistance is relatively inexpensive and by providing job seekers with better information on jobs, it can also help in shortening unemployment spells. On the negative side, these interventions usually have "deadweight losses" - i.e., individuals who find jobs through these services are generally more qualified than most job-seekers and many likely would have found jobs even in the absence of these services. Training and retraining should be provided for lay-offs. Program effectiveness benefits from on-the-job training and employer involvement. Specially designed and targeted programs and placement services should be provided for the youth, women, disabled, and long-term unemployed. Youth employment problems are more effectively addressed through earlier, education-related interventions.

Assistance in self-employment and in other job creation programs should be provided including micro credit programs and start-up loans or grants. Although take-up is usually very low, some of the programs are relatively inexpensive and can be proposed to carefully selected job seekers, including small business advisory services or even small-scale micro credit programs. Small business incubators Incubation services are rather costly but can contribute significantly to job creation and redevelopment in economically depressed areas.

Local economic development planning studies can be implemented. These studies help strengthen capacities, especially of poor communities and municipalities, to develop the local economy and generate new employment by identifying and marketing regional resources and opportunities to potential investors and finding local solutions, including sources of funding.

Social monitoring and evaluation. Evaluation and monitoring of pre-layoff and post-layoff activities should be undertaken. Monitoring of labour re-deployment programmes is critical to ensure that displaced workers get their entitled benefits in a timely manner, that they are not rehired via a "back door," and workers who have difficulty in re-entering the labour market are identified early and given targeted assistance to ensure they do not slip into poverty.

2.5.5. Socially Responsible Restructuring: Practices and Experience

As mentioned before, restructuring often results in significant downsizing of labour, when this occurs a negative social reaction can slow and /or tall restructuring. This is increasingly recognized by development agencies, governments, and enterprise managers and as a result social programme are increasingly becoming part of the design of restructuring programs.

However, the social support programmes which can influence the restructuring to be successfully implemented and mitigate the negative impact on the stakeholders, particularly, employees and workers (Fretwell 2004). Fretwell (2004 argues that the effective social support programs should include elements that combine to "pull" and entice excess labour to leave overstaffed enterprises, while at the same time helping "push" and assist displaced workers to quickly rejoin the labour market. These measures usually include both temporary income support and active labour programs. To be effective, the measures must be carefully designed and targeted. Furthermore, there should be continuing social monitoring of displaced workers to ensure the services are reaching the most needy workers and the most vulnerable are identified early and provided with special assistance as needed.

Fretwell (2004) also provides international experience of implementation of social support programmes by examining 12 case studies of enterprise divestiture in Europe, Latin America and Asia. Although the design and use of social support programs varies considerably between countries and is greatly influenced by the economic environment, including the level of unemployment, and type of general social support programs already in place in the country where economic restructuring is occurring, the social support programs is indeed instituted to mitigate the social impact. For example:

· *Latin America: In Brazil,* a varied set of income support and other support packages were used to retrench workers between 1995 and 1997 in six SOEs, including three banks and three utilities. A parallel program was carried out by several states. Severance payments were a core element of the program, plus extended medical benefits, retraining, help for business start-ups and job search assistance to affected workers. Economic restructuring in Latin America was sometimes carried out in a manner and in an environment that increased employment, thus making divestiture more palatable to labour. For example, *in Chile,* employment in 10 state owned companies privatized between 1985 and 1990 increased 10% because of overall headway achieved in economic growth and investment by the firms involved (Larroulet, 1992). *In Argentina,* starting from a base of 222,000 employees in 13 major public enterprises in 1990, employment was reduced to about 42,000 by 1993 via transferring 66,000 workers to private firms, retiring 19,000, and providing 95,000 with severance payments. The advanced age of many workers, generous severance, multi-job holding phenomena, reactivation of the economy and expanding labour market are credited for producing a lack of opposition from labour (World Bank, 1993; Guasch, 1996).

· *Western Europe: In Germany* a new institution, the Ttruhandanstalt was established to deal with rapid privatization of some 8,000 state companies, with a workforce of 4.1 million. The privatization program had an immediate and severe impact on employment. Labour reductions were achieved by early retirement, job placement in new private firms, employment creation schemes including wage subsidies, public works, and retraining; plus unemployment benefits. Special employment companies and counselling services were also established to employ and retrain workers. *In the UK,* British Coal divested a total of 204,000 workers, mostly over the age of 50, who accepted lump sum redundancy payments. In addition, British Coal Enterprise Ltd. was established to assist employees in the sector, and their families, in developing skills and securing new employment with a special emphasis on helping displaced workers start small businesses. *In Sweden,* the Uddevalla shipyard was downsized via normal turnover, early retirement, a freeze on recruitment, and assistance with job search and retraining. The KLAB mine was downsized by normal and early retirement, severance, and retraining.

· *In Eastern Europe:* Privatization in transition economies often took place in a difficult environment where the economy in contracting, and unemployment rising. In

Poland, restructuring in the Coal Sector was supported by a Miners' Social Package which included lump sum payments, early retirement assistance, combined with active labour programs (e.g., small business assistance, counselling, retraining) and local economic development assistance to affected communities. *In Macedonia,* severance payments were combined with active labour programs to assist workers affected by restructuring of 25 large loss-makers. Approximately, one-third of affected workers participated in the latter services. An added complication in the transition economies is the fact that often a large number of community services (e.g., schools, hospitals, heating, housing) are connected with state enterprises; and when these enterprises are liquidated or downsized these social assets must be disbursed in a manner that would ensure that essential community social services are maintained. *In Turkey,* a generic job loss compensation package is defined in the Privatization Law, and this is supported by a broad array of active labour redeployment programs and related social monitoring activities.

Most successful programs include direct dialogue between key stakeholders (e.g., the government, enterprise management, workers, and community leaders) both before and during the restructuring program. The stress and emphasis on income support (e.g., severance) vs. other forms of support (e.g., labour services) vary depending on economic and employment conditions, but most programs include both elements to varying degrees. Any new SSP should draw on this and on worldwide experience, and must be designed in a manner responsive to current conditions in a specific country. Finally, enterprise restructuring is not a "one-off" process. Enterprises in the most developed economies must continue to reinvent and restructure themselves in response to changing economic and market conditions worldwide. As such, developing countries need to develop SSPs that have both short and long-run applications

Chapter 3 Enterprise Reform and Restructuring in China

3.1 Introduction

As a prelude to the empirical study of relationship between socially responsible restructuring and firm's performance, this chapter presents the macro-economic background and policies, in particular, its impact on economic reform and enterprise restructuring. The important turning points of economic reform and policymaking since 1978 will be reviewed to give us with assessment of environment in which enterprises are restructuring and developing, and to identify the progress and constraints in enterprise restructuring and privatization in China. This chapter also analyzes China's enterprise reform process and its impact on corporate governance and social welfare.

The enterprise reforms in China have three main components, the first component comprises SOE privatization and restructuring to alleviate the problems that are impairing enterprises' ability to compete. A second component is to improve enterprise behaviour by establishing effective corporate governance mechanisms and strengthening financial discipline. A third one is provision of supporting institutions and infrastructure needed for a market based enterprise economy. Key in this regard is the development of social benefit programs to deal with the economy adjustments entailed by reforms, allow enterprises to focus on their commercial objectives, and provide for the longer term needs of the population.

This chapter is organized as following a brief overview of economic background, Section 2 examines the main elements and characteristics of enterprise reforms in China, Section 3 reviews reforms to bolster enterprise performances and to restructure and privatize the SOE sector; to establish effective corporate governance mechanisms (Section 4); Finally in Section 5, the social impact of SOE reform and restructuring is also investigated.

3.2. Reforming China's Enterprises: Overview

This section examines progress on reforms shaping the development of China's enterprise sectors. The analysis covers not only state-owned enterprises, which have been the main focus of the explicit reform measures, but also non-state enterprises, which have been the most dynamic elements of the economy. The basic purpose is to describe the main reforms that are shaping the evolution of the enterprise sectors; the problems they are intended to remedy; the progress being made; and the issues that remain to be addressed. These reforms involve nearly all the main dimensions of the broader economic reform process in China, including policies that, while directed at other areas, have an important bearing on enterprise performances.

The analysis takes as given the basic goals of the reform process in China and the distinctive features of the Chinese economy and society that condition that process. China's reform process is different from that of other countries in certain respects. At the same time, experiences of developed countries and other emerging market economies provide insights about the fundamental economic processes involved in systemic changes that are potentially relevant to China's reform efforts.

3.2.1. Objectives, Constraints, and Conditioning Factors

The overall objective of China's reform process is to create a "market economy with socialist characteristics". This means an economy in which substantial public ownership of industry is retained; but where enterprises, regardless of their ownership, seek to maximise profits in response to market forces in essentially the same manner as enterprises in other economies. This objective is not itself unique and indeed is compatible with the mixed economy approach embraced by several western European countries during the first half of the post-war era, and by several central European countries during the 1970s and 1980s. As in other transition economies, creation of a market economy is seen as less of an end in itself than a necessary means toward realizing the country's full potential for growth and development in a manner consistent with its social objectives. These two closely related objectives, the creation of a market based economy and realization of growth potential, are the benchmarks against which progress on enterprise reforms must ultimately be measured.

The move toward a market-based economy is already far along. Most products prices, and to a lesser extent wages, are free to vary with market conditions. [8]

[8] World Bank (1994), a number of energy and agricultural prices remain subject to controls, although these are being relaxed. Labour markets are quite rigid and labour mobility is still quite low, as is the mobility of products and factors among regions.

Competition is strong in many although not all industries. The economic behaviour of enterprises has become increasingly responsive to market forces as a result of competition, the growth of non-state enterprises, and management reforms to SOE carried out in the 1980s (Naughton 1994). The main tasks remaining are to convert state enterprises into modern commercial entities, restructure and privatize the enterprise sectors, develop financial, legal, and other institutions necessary to the functioning of a market economy, and to complete the opening of the domestic economy to international markets.

Economic reform in China is shaped by several distinctive characteristics, reflecting policy-imposed constraints and other special characteristics of the economy, that need to be taken into account in drawing conclusions about the process. The first characteristic reflects the fundamental policy choice that significant public ownership and control of industry will be retained. This choice partly explains why enterprise reforms have been so heavily focused on SOE. Although often viewed as necessary for economic development in its earlier stages, public ownership in China is also seen as necessary to preserve social equity and other values; in that sense it is an objective (or constraint) and not simply a means of reform. These values are also reflected in some remaining ambivalence about the appropriateness of wide-scale private ownership of industry and a preference for collective ownership forms in the non-state sector. However, the scope of public ownership has been substantially narrowed in recent years while the scope for private ownership has been widened.

A second factor conditioning the reform process is gradualism: economic reform has been underway for over two decades and under current plans will continue for at least the next decade.[5] The choice of gradualism reflects official belief that very rapid reforms in an economy as vast as China are prone to go off track and produce socially unacceptable disruptions.[6] The need to avoid socially unacceptable disruptions also conditions reforms in other ways, although it is recognized that reform inevitably entails painful adjustments for some segments of the economy and that reform's benefits will be unevenly distributed for some time.[7] Gradualism in reform has also been an evolutionary process rather than derived from a single comprehensive "master" plan. The goals of reform and the modalities for achieving them have broadened progressively over time. Finally, gradualism has not been a smooth process in which all reforms proceed at the same pace. Rather it has been marked by periodic "leaps", such as the freeing of agricultural prices at the beginning of reforms and the creation of special economic zones in the late 1980s, which have fundamentally altered the forces shaping the economy's development. Presently, the severe problems of much of the enterprise sector, the growing strains on fiscal resources, and the prospect of WTO entry mean that fairly rapid progress on a wide range of reforms is necessary if the overall reform process is to be sustained.

Apart from these constraints, the economic reform process is strongly conditioned by several features of the economic policy process itself. Particularly important is the relatively low level of government revenues, which are partly a result of past reforms and partly a reflection of structural problems current reforms are trying to address. As will be seen repeatedly in the subsequent sections, limits on government revenues constrain both the pace of reforms, the specific options available to implement them, and the immediate benefits enterprises derive from the reforms. Limited government revenues magnify existing distortions in taxation, as a number of key reforms impose implicit taxes on successful SOE to support financially weaker enterprises.

Also important is the substantial decentralization in the implementation of reforms, and many other economic decisions, to provincial and other local authorities. Most state-owned enterprises are controlled by provincial and urban authorities, while local governments have (at least) a major role in township and village enterprises (Che and Qian 1998; Naughton 1994). Provincial and local authorities, while subject to central government decisions about the overall parameters of individual reforms, typically have significant latitude in determining how they will be carried out. This decentralization complicates the task of assessing the progress of economic reforms in China, since much of what is happening at provincial and local levels is not systematically compiled or reported. This regionalism in policy implementation has had both adverse and beneficial effects on China's overall reform process. Responding to soft budget constraints and regional barriers to competition, regional authorities were instrumental in the early 1990s investment boom that has been the source of many of the present problems of China's enterprises. At the same time, regional authorities have strong incentives to promote development of their regions since their advancement depends to an important degree on its success. The result has been a growing regional dynamic in the overall reform process that is likely to become increasingly important in coming years.[9]

3.2.2. The Key Reform Stages

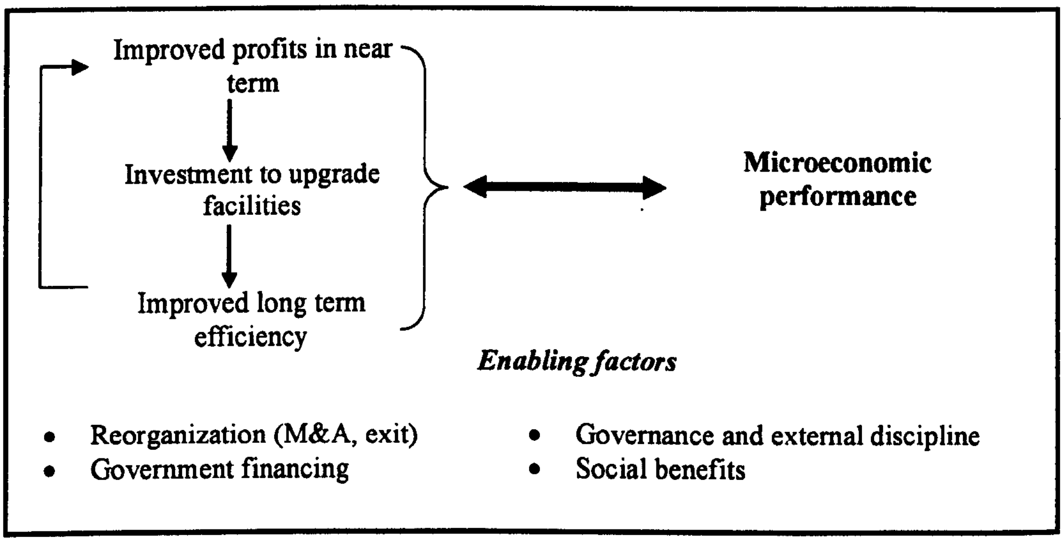
The process of reforming China's enterprises involves many individual measures in a wide range of areas. The basic strategy is to improve enterprise financial performance in the near term in order to generate resources to upgrade productive facilities and other key capabilities; with the ultimate goal of achieving sustained improvement in efficiency and competitive viability in the long term. These measures are highly interdependent and success depends ultimately on sustaining a positive dynamic or "virtuous circle", of mutually reinforcing progress on a wide range of reforms. As indicated Figure 3-1, this dynamic involves key "enabling" factors, such as improvements in corporate governance to ensure that enterprises make effective use of increased profits. Success also requires a positive dynamic between the reform process and the growth of the economy as a whole. Adequate real growth is needed to ensure the success of measures to boost enterprise profitability, as well as to allow the economy to absorb workers displaced in the course of reforms. At the same time, progress on the reforms is necessary to contain and ultimately reduce the deflationary forces generated by the structural problems of enterprises.

For the discussion that follows, it is helpful to consider the individual reforms in terms of three basic objectives, as summarized in Figure 3-2. The first is to improve performances of enterprises so that they are technically capable of competing in a market environment. Policies to improve performances are largely focused on problems that have accumulated over time because of remaining distortions in the economy. There are two related components to these efforts. The first is industrial restructuring to bolster financial conditions in the medium term and to improve efficiency over the longer term. The second is privatization and restructuring of the SOE sector so that it is viable on its own and can serve as the "core" of China's efforts to secure the international competitiveness of its key industries. The effort to improve enterprise performances has become perhaps the most pressing element of reform in the near term, in part because it

[9] For extensive analysis of the regional dimensions of China's economic reform processes, see *China's provinces in reform (1997)* edited by David Goodman.

is most necessary to reviving growth, facilitating China's adjustment to WTO entry, and freeing up government resources so that they can support other areas of reform. However reforms that are fundamental in the longer term, such as better corporate governance, are unlikely to succeed until enterprises are technically capable of competing in a market environment.

Figure 3- 1 Dynamic of Sustainable Reform



The second key objective of enterprise reforms is to improve enterprise behaviour to ensure that enterprises respond appropriately to market forces. These reforms are necessary to ensure that near term improvements in enterprise financial performances lead to greater efficiency in the long term, and to prevent problems that have impaired financial performances (many of which stem from past distortions in enterprise behaviour) from recurring.

Two sets of measures are most critical in this respect. The first are policies to establish mechanisms for effective corporate governance by transforming ownership structures, clarifying and strengthening property rights, separating enterprise management from government operations, and providing internal incentives and oversight mechanisms so that management acts in the interest of owners. The key priority in this area is to meet a challenge many developed countries have faced and in some cases continue to face: namely to ensure effective governance of state-owned enterprises.

However, there are also governance issues concerning the non-state sector. The second set of measures are financial system reforms to ensure that credit is allocated to enterprises on the basis of sound commercial principals, rather than on the basis of government mandates or other social considerations, as has been the case in the past. Reforms to develop and broaden the financial system are also necessary to accommodate the development of the non-state enterprise sectors as well as to facilitate the ongoing restructuring that is likely to be needed as the economy evolves. As historical experience, including that of China has amply demonstrated, good corporate governance mechanisms will not prevent enterprises from engaging in economically inefficient or disruptive behaviour if they are faced with distorted financial incentives. The third set of reform objectives involves the supporting institutions and infrastructure needed to allow enterprises to pursue their commercial objectives in a manner consistent with the overall objectives of society. These include ongoing efforts to level the playing field among various types of enterprises and to provide for the enforcement of contractual obligations that are needed to support reforms to corporate governance and the external environment.

A major present priority is social security reforms to socialize as well as broaden the quasi-governmental social welfare functions that have largely been provided by state-owned enterprises. Policies in this area involve restructuring, consolidation, and, in some cases, creation of systems to provide health services, pensions, and unemployment insurance and to establish economically efficient arrangements for their financing.

Figure 3- 2 Schematic of the enterprise reform process

Major Objectives	*Primary Focus*	*Key Tasks*
Improving performances (Ensuring enterprises are capable of competing in the market)		
Industrial Restructuring	SOE	Improve profitability by reducing excess capacity; shedding surplus labour, lowering debt loads; and upgrading productive capacity. Facilitate business reorganizations to reduce industry excess capacity and improve economics of scale and scope; release resources by promoting exit of unviable firms
Privatization/Restructuring of the	SOE	Establish the "strategic core" where

SOE Sector		SOE will be concentrated while facilitating the withdrawal of state ownership and control from other "competitive" industries where state intervention is not needed.
Improving behaviour (Ensuring enterprises respond appropriately to market forces)		
Establish effective corporate governance mechanisms	SOE	Establish modern ownership forms ("corporatization") clarify ownership and control rights; separate government from enterprise management; establish effective oversight mechanisms for enterprise owners.
Financial system reform	Financial System	Provide adequate financing outlets for non-state as well as state enterprise sectors; establish credit allocation on commercial standards and exert financial discipline; provide mechanisms to transfer ownership and provide a market for corporate control.
Supporting institutions and infrastructure (Ensuring compatibility between commercial objectives and social needs)		
Social security reform	Workers	Reduce SOE burdens for social security; establish "portable" pension and other benefit systems to improve the functioning of labour markets.
Legal and regulatory reforms	Enterprises	Clarify property rights; strengthen enforcement of contractual obligations.
Fiscal reforms	Enterprises and society	Reduce tax disparities among enterprises; increase and broaden revenue resources needed to facilitate adjustments caused by reforms and to socialize certain burdens now borne by enterprises.

Source: OECD, *犟hina in Global Economy: Reforming China犻Enterprises? 2005.*

3.2.3. China's Enterprise Sectors: the Current Situation

China's economy has become increasingly diversified over the past two decades as the importance of state-owned enterprises has progressively declined. Non-state enterprises now account for nearly three-quarters of industrial output and have been the dominant contributors to overall economic growth and the main source of new jobs during the past ten years.

The financial performances of enterprises have deteriorated markedly in recent years. The majority of SOE are at best marginally profitable and a large portion of collective enterprises are also in serious financial difficulties. The poor financial performances are attributable to a range of factors. These include excess capacity built up during the investment boom earlier in the 1990s; and heavy financial burdens from high debt loads, surplus labour, and social welfare expenses normally borne by government or society at large in other countries. SOE as well as large numbers of non-state enterprises are also suffering from extensive operating inefficiencies due to sub-optimal scale and scope in their operations, outmoded equipment and technology, and poor product quality.

China's Enterprise Sector: A Profile

China's enterprise sectors include four main ownership classes: state-owned enterprises (SOEs); collectives, comprising township and village enterprises (TVE) in rural areas and urban co-operatives; foreign-funded enterprises; and individually owned or other private enterprises. The oldest class, SOE, is confined to urban areas. These enterprises are still mainly wholly government owned and subject to the direction of government agencies, although these situations are changing. The majority of large SOEs are controlled by central government authorities, while nearly all medium - size and smaller SOEs are under the control of municipal or other local authorities. Collectives are usually legally owned by their workers and/or management, but in practice local governments often have a controlling or at least major role in their management (Che and Qian, 1998). However, many of these enterprises are effectively privately owned but registered as collectives. Production of collectives is heavily concentrated in consumer and, to a lesser extent, export products. SOEs and collectives together make up the public enterprise sector.

Since the economic reform started, China has developed a highly diversified and complicated enterprise sector. In particular, in September 1998, China's economic sectors were re-classified because of the changes in the ownership structure in the social and economic domains in the past years. According to the new re-classification, the economic sector system is categorized as *Public Economy* - state-owned economy and collective economy; and *non-public economy* - privately-owned economy; Hong Kong-Macao- and Taiwan-funded economy, and Foreign-funded economy.

Accordingly, in general, enterprises can be classified according to two basic criteria: by ownership and by legal form. A brief description of the definitional categories of enterprises are described according to these two criteria

Enterprises categorized by ownership

State-owned enterprises (SOE) refer to industrial enterprises where the means of production or income are owned by the state. Joint state-private industries and private industries, which existed before 1957, have been transformed into state industries. Statistics on these enterprises has been included in the state-owned industries since 1957 when separation of data was no longer necessary. The legal basis was established in 1988 with the promulgation of the *Law on Enterprises Owned by the Whole People*, which defined an SOE as a legal person with the state as the sole (or majority) owner. Its liability is limited to the amount of assets authorized by the state.

Collectively-owned enterprises (COE) refer to industrial enterprises where the means of production are owned collectively, including urban and rural enterprises invested by collectives and some enterprises which were formerly owned privately but have been registered in industrial and commercial administration agency as collective units through raising fund from the public. The COE are subject to the *Law on Collectively-Owned Enterprises* (1991).

Private Enterprises refer to economic units invested or controlled (by holding the majority of the shares) by natural persons who hire labours for profit-making activities, including private limited liability corporations, private share-holding corporations Ltd., private partnership enterprises and private sole investment enterprises registered in accordance with the Corporation Law, Partnership Enterprise Law and Tentative Regulation on Private Enterprises. Although their existence and growth were allowed after 1978, the legal status of private firms was not established until 1988, when the National People's Congress passed an amendment to the Constitution of the PRC recognizing their positive role in the national economy and promulgated the *Provisional Regulations on Private Enterprises*. The regulations defined private enterprises as economic entities with eight or more employees and whose assets are owned by individuals. The regulations further distinguished between three types of private enterprises: *1) individually-funded enterprises* funded and managed by one person; *2) partnerships* funded and managed, and profits shared and losses borne jointly, by two or more persons under a legal contractual agreement; and *3) limited liability companies* in which the liability of investors to the company is limited to their respective contributions and the company's liabilities are limited to the extent of its assets.

Foreign enterprises. Foreign enterprises include joint ventures, Sino-foreign co-operation enterprises and wholly foreign-owned enterprises. Each of the three types of enterprises is subject to a separate set of laws. Where these foreign enterprises are incorporated as limited liability companies or limited joint-stock companies, they are also subject to the Company Law.

Enterprises categorized by legal forms

Prior to 1994, limited liability corporate legal forms of the type dominant in other market economies were largely unavailable to Chinese domestic enterprises. This situation was changed by the Company Law enacted in 1994, which provided for the establishment of limited liability companies (LLC) and limited joint-stock companies (JSC). Both types are defined as enterprise legal persons and shareholders enjoy limited liability.

Limited liability companies (LLC). In a LLC, shareholders are liable towards the company to the extent of their respective capital contribution, and the company is liable for its debts to the extent of all its assets. A LLC is established by capital contributions made jointly by between two and fifty shareholders, with the registered capital not less than 100,000 yuan for consultancy and services companies, not less than 300,000 yuan for retailing companies and not less than 500,000 yuan for manufacturing or wholesale trade companies.

A wholly state-owned company (SOC) is a special kind of LLC. SOC is essentially SOE in the guise of a modern corporation - subject to the Company Law rather than to the Enterprise Law. The SOC can be established only by an organization, institution or department explicitly authorized by the state to make state-approved investments. This corporate form applies mainly to companies engaged in special lines of production or trade, such as infrastructure and other strategic industries, specifically designated by the State Council.

Limited joint-stock or share-holding companies (JSC). Ownership of JSC is divided into shares of equal value, with the shareholders liable towards the company to the extent of their respective shareholdings and the company liable for debts to the extent of all its assets. Normally, the establishment of a JSC requires a minimum of five "promoters" (founding shareholders). However the law permits a single promoter when that promoter is an SOE.

The LLC and JSC forms are available to non-state enterprises that were formed under the earlier laws based on ownership described above. Many COEs are being converted into a hybrid form, known as "joint-stock collectives" in which ownership shares are distributed to workers and other stakeholders, but where the shares generally cannot be held by outsiders.

Table 3- 1 Ownership Profile of Chinese industry, 2003

	Number of Firms	*Share of firms (%)*	*Gross Industrial Output (100 million)*	*Share of industrial Output (%)*
Total	**196,222**	**100**	**142,271.22**	**100**
State-owned enterprises	23,228	11.83	18479.40	12.99
Collective-owned enterprises	22,478	11.46	9458.43	6.65
Private enterprises	67,607	34.45	20980.23	14.75
Foreign Funded Enterprises	17,429	8.88	26932.18	18.93
Limited liability companies	26,606	13.56	26583.94	18.69
Wholly state-owned companies	1,330	0.68	7073.68	4.97
Shareholding companies	6,313	3.22	18017.06	12.66

Source: China Statistical Yearbook 2004, Table 14-1

As indicated in Table 3-1, China has totally 196,222 firms, of which, there are 23,228 SOEs, accounting for 11.83 percent of total enterprises, and contributing 12.99 per cent of total industrial output in 2003, while 22,478 collective-owned enterprises (COEs), which are dominated in output terms by TVE, accounted for 11.46, and contributed nearly 6.65 per cent of the total. The number of SOEs has been reduced nearly fifty percent since 1998, but SOE share of industrial output has increased steadily throughout the same period (Table 3-2), even though during the 1980s, it gave way to the rapidly growing TVE. The private-owned enterprises are regarded as the engine of economic development and play a central role of China economy and employment.

Table 3-1 also shows that in 2003, the number of private-owned enterprises accounts for 34.45 percent, contributed 14.75% of total industrial output. During the late 1990s when the Chinese government implement new strategic restructuring programme, with the slogan of "grasping the large and letting go the small" (*zhuada fangxiao*), the government planned to save China's 1,000 largest state enterprises while letting smaller, money-losing companies be merged, taken over by private investors, or dissolved. As a result of the reform, number of collective-owned enterprises (COEs) has been dramatically reduced more than 50 percent from 1998 to 2003, share of COEs' output has declined accordingly.

Since 1992, China has been experimenting with Western-style corporate forms as a way to improve the performance of Chinese companies. Dubbed *gufenzhi gaizao*, or transformation through the shareholding system, the objective of this process has been the creation of a "modern enterprise system" through the restructuring of state-owned enterprises (SOEs) into limited liability companies and joint stock companies under the PRC Company Law (1993). Table 3-1 and 3-2 shows us the development trends of shareholding companies, which increased about 53.2 percent from 1998 to 2003. From an aggregate point of view, SOE in no sense dominate the industrial economy, although they are much more important in wholesale and retail trade, and do dominate transportation, utilities, finance, and education.

In several key respects, though, the importance of the SOE sector in the economy is greater than its aggregate share of industrial output indicates. First, SOE account for nearly 30 percent of total urban employment (Table 3-3). Second, SOE dominate output of large enterprises and their share of heavy industry is also considerably higher than that of industry as a whole. Partly because of their concentration in heavy industry, the SOE shares of industry fixed assets and investment are significantly greater than their share of output. Third, the SOE share of industrial output is well above the national average in the majority of Chinese provinces (Table 3-4). SOE shares are lowest in the coastal provinces. These provinces have been the most rapidly growing regions; and have the largest share of overall industrial output. TVE and other non-state enterprises have generally received the most favourable treatment from local governments in the coastal provinces. Finally, partly because of their past historical dominance but also because authorities have given more favourable tax treatment to non-state enterprises, SOE supply the largest share of tax revenues coming from the enterprise sectors.

From the perspective of their contribution to growth in aggregate output and employment, however, SOE have been even less prominent than their share of total output would suggest. Real growth of SOE output has consistently lagged that of collective enterprises since the early 1980s and since 1990 has been the slowest among the four major ownership classes. Collectives have been the largest contributors to overall industrial sector growth for most of the period since 1985, although they have been nearly overtaken in this respect in recent years by the private enterprise group. The decline in the contribution of SOE to employment is even starker. SOE accounted for nearly 35 per cent of the total growth in urban employment between 1985 and 1990, but less than 20 per cent of the overall increase between 1990 and 1997. SOE employment virtually stagnated between 1994 and 1996 and fell by nearly three million in the subsequent two years. With employment in urban collectives also on the decline, the private enterprise sector is supplying virtually all of the net growth in jobs that is occurring in the urban economy. TVE together with private enterprises are also the main source of employment growth in rural areas.

Table 3- 2 Number of Firms 1998-2003

Year	*SOEs*		*Collective-Owned*		*Private-owned*		*Shareholding*		*Foreign-funded*	
	No. of Firms	Gross Industrial Output (100 mil)	No. of Firms	Gross Industrial Output (100 mil.)	No. of Firms	Gross Industrial Output (100 mil)	No. of Firms	Gross Industrial Output (100 mil)	No. of Firms	Gross Industrial Output (100 mil.)
1998	64737	33621.04	47745	13179.67	60338	20372.00	4120	4334.46	10717	8458.43
1999	61301	35571.18	42585	12414.11	61268	22928.00	4480	5247.08	11054	9960.23
2000	53489	40554.37	37841	11907.92	22128	5220.36	5086	10090.29	11955	12890.25
2001	46767	42408.49	31018	10052.49	36218	8760.89	5692	12698.34	13166	15373.72
2002	41125	45178.96	27477	9618.95	49176	12950.86	5998	14119.03	14920	18790.47
2003	34280	53407.90	22478	9458.43	67607	20980.23	6313	18017.06	17429	26932.18

Source: China Statistical Yearbook, various versions

Table 3- 3 Employment by type of ownership, 2003

	Total Employment (in million)	Per cent of total
Urban Employment-Total	**256.39**	**100**
SOE	68.76	26.82
Collective	10.00	3.9
Private and Individually owned	49.22	19.20
All others	128.41	50.08
Rural Employment-Total	**487.93**	**100**
TVE	135.73	27.82
Private and Individually owned	40.14	8.23
All others	312.06	63.95

Source: China Statistical Yearbook 2004, Table 5-4

Table 3- 4 SOE shares of industrial output by region and province, 2003

Region	*Province*	*Number of SOE Firms*	*SOE Share of Total Firms*	*SOE Gross Industrial Output (100 mil. yuan)*	*SOE Share of gross industrial output (%)*
Total		34280		53407.90	
North China	Beijing	1362	3.97	2051.79	3.84
	Tianjin	1625	4.74	1456.51	2.73
	Hebei	1675	4.89	2360.39	4.42
	Shanxi	1354	3.95	1381.77	2.59
	Inner Mongolia	591	1.72	798.51	1.50
Northeast China	Liaoning	1334	3.89	3552.29	6.65
	Jilin	969	2.83	2017.7	3.78
	Heilongjiang	970	2.83	2311.94	4.33
East China	Shanghai	1606	4.68	4466.43	8.36
	Jiangsu	1242	3.62	3422.44	6.41
	Zhejiang	861	2.51	1686.99	3.16
	Anhui	747	2.18	1438.88	2.69
	Fujian	888	2.59	1125.72	2.11
	Jiangxi	1071	3.12	946.60	1.77
	Shandong	1961	5.72	5148.72	9.64
Central-South China	Henan	2253	6.57	2718.98	5.09
	Hubei	1617	4.72	2287.46	4.28
	Hunan	1642	4.79	1391.74	2.61
	Guangdong	2103	6.13	3949.03	7.39
	Guangxi	1252	3.65	797.95	1.49
	Hainan	346	1.01	213.56	0.40
West China	Chongqing	570	1.66	852.72	1.60
	Sichuan	1065	3.11	1609.79	3.01
	Guizhou	1037	3.03	667.75	1.25
	Yunnan	943	2.75	1145.91	2.15

	Tibet	199	0.58	16.76	0.03
Northwest China	Shaanxi	1235	3.60	1392.06	2.61
	Gansu	706	2.06	880.76	1.65
	Qinghai	206	0.60	195.01	0.37
	Ningxia	154	0.45	211.74	0.40
	Xinjiang	696	2.03	909.99	1.70

Note: Figures refer to industrial enterprises at the township level or above.
Source: China Statistical Yearbook, 2004, Table.14-2.

The rapid growth of non-state enterprises is partly the result of deliberate government policies to encourage their development. Beginning in the early 1980s, TVE were largely detached from central planning requirements and their growth was promoted by local authorities in order to bolster rural employment and to provide revenues to local governments. The creation of special economic zones (SEZ) in the late 1980s and relaxation of restrictions on foreign investment has fostered the rapid growth of foreign funded enterprises. Legal changes sanctioning the growth of private ownership have been essential to the development of private enterprises. However, other government policies, notably those governing access to bank financing and financial support from government agencies have favoured SOE over non-state enterprises. The ultimate success of non-state enterprise derives from their more effective economic performances. In particular, the growth rate of productivity of collective enterprises has been higher than that of SOE.[10] This economic success is attributable in large part to the relative freedom of non-state enterprises from government interference in their management and their harder budget constraints (Che and Qian, 1998).

While important, the distinctions among the various ownership classes are not as clear cut as is sometimes supposed. This is particularly true of TVE and SOE. While their performance and behaviour is often contrasted, in practice their relations are partly complementary and partly competitive. In particular, SOE have fostered the growth of TVE as a means of getting around central planning constraints and to lower costs. TVE and other collectives serve as suppliers to SOE or provide other complementary

[10] For a recent review of studies of factor productivity in China's enterprises, see Jefferson, Singh, Xing, and Zhang (1999). Their conclusion that SOE productivity growth has been moderately positive contrasts with other analysis suggesting virtual stagnation in SOE productivity growth during the 1980s (Woo et al. 1994).

productive facilities, while SOE often provide financing for TVE operations. Moreover, as discussed further in later chapters, distinctions among the ownership types are becoming even more blurred with economic reforms, with both TVE and many SOE moving toward forms that more closely resemble private ownership.

The past ability of the non-state sector to flourish largely on its own partly explains why it so far has been given only limited emphasis in enterprise reform plans. However, as noted below, many non-state enterprises are now experiencing serious economic performance problems.

Enterprise financial performances: deteriorated or improved?

As is well known, SOE are facing very serious problems in their economic and financial performances in the 1980s, detailed examination of available data on enterprise performance through 1998 amply confirms this impression. Many of China's large and medium-sized SOEs reported deficits in 1997. At the end of the year, the Chinese government set a goal for these enterprises to climb out of poverty and establish a modern corporate system within three years. By the end of 2000, 70 percent of China's large and medium-sized SOEs had built up a corporate system, and the proportion has topped 85 percent among those ranked as national key enterprises.

A first observation is that profit rates of SOE along with much of the non-state sector have been declining since the late 1980s (Table 3-5 and 3-6). The industrial SOE after-tax profit rate (relative to fixed assets) was nearly 18.21 percent in 1978 but had fallen to below six percent by 2000. This secular decline is substantially attributable to the increasing competition engendered by the entry of non-state firms. Initially, SOE and the new entrants, which were primarily TVE, enjoyed substantial monopoly rents that were progressively eroded over time as competition intensified and as constraints on prices were relaxed (see Naughton 1994; Jefferson and Rawski 1994). SOE and TVE profitability have come under further pressure from the rapid growth during the 1990s of foreign-funded and domestic private firms. However, it has been SOE that have been most severely affected by increasing competition.

Table 3- 5 Losses and Profits of Industrial SOEs, 1978-2000

Year	*Losses (1978 prices in billion yuan)*	*Losses/gross profit (%)*	*Return on assets[a] (%)*	*Social Return on assets[b] (%)*	*Profit/sales revenue[c] (%)*	*Profit+taxes/ sales revenue[c] (%)*
1978	4.21	7.64	16.09	24.70	18.21	28.30
1985	2.89	4.21	14.53	25.17	14.08	25.44
1986	1.54	8.71	12.35	22.38	11.59	22.53
1987	4.85	7.20	12.37	22.12	11.01	21.17
1988	5.66	8.41	12.37	22.64	9.95	19.80
1989	10.50	19.52	10.14	20.13	7.38	17.60
1990	19.53	47.33	5.96	15.19	3.66	14.18
1991	19.35	47.71	5.35	14.29	3.17	13.11
1992	18.23	40.83	5.82	14.57	3.50	12.72
1993	18.02	35.64	4.07	9.09	3.89	11.69
1994	16.08	36.79	4.85	10.17	3.88	13.47
1995	18.54	49.00	4.45	9.10	2.63	11.35
1996	22.28	65.71	3.52	7.92	1.57	10.41
1997	23.48	66.01	3.02	7.21	1.58	10.74
1998	33.91	68.66	2.72	6.52	1.61	10.35
1999	29.19	49.21	2.99	6.82	2.86	11.69
2000	20.69	22.63	4.33	8.46	5.87	14.32

Note: a. Return on assets denotes profit plus (net) financial charges, per unit of assets? where assets prior to 1993 comprise only average annual fixed-quota working capital plus year-end net fixed assets. 1993 assets are the sum of liabilities and equity. Net financial charges prior to 1993 are approximated as average annual interest rate on short-term (i.e. working capital) loans of maximally 6 months duration times total short-term borrowing (i.e. borrowing of less than 1 year maturity) by industrial SOEs; in 1993 the approximated value exceeds the actual value by 4.36 percent.

b. Social return on asserts denotes profit plus taxes plus (net) financial charges, per unit of assets?

c. Sales revenue is net of all sales-related taxes.

Source: Carsten A. Holz (2002), Long Live China's State-owned Enterprise: Deflating the Myth of Poor Financial Performance", Journal of Asian Economics, Vol. 13, P497.

Profit rates continued to decline throughout the 1990s and have now reached very low levels. The industrial SOE after-tax profit ratio to fixed assets fell to 3.0 per cent in 1996-1997, and then dropped further to about 2.99 per cent in 1998,[11] although there was some rebound in 2000. The after-tax profit rate of collective enterprises has also fallen but it remains higher than that of SOE. These profit ratios are low, at least in after-tax terms, compared to OECD countries, and particularly low given that China is a rapidly developing country. These low profit rates suggest serious structural problems in SOE performances.

Other indicators of SOE performance have also deteriorated over time. Total losses of loss-making SOE rose sharply during the latter half of the 1990s and reached

[11] OECD (2000), "China in the Global Economy: Reforming China's Enterprise".

their peak in relation to output in 1990 (Table 3-5); the ratio then fell through 1995, but has since risen back. SOE losses now account for about half the losses of all industrial firms but are only slightly more than 1 per cent of GDP. The ratio of total liabilities to assets for SOE increased from a fairly low level in the early 1980s to reach a peak of nearly 70 per cent in the mid-1990s, although it has since fallen back somewhat. The current average ratio (62.4 per cent) corresponds to a debt-equity ratio of nearly two and is high compared to those of most OECD countries, although not out of line with the ratios in Korea, Thailand, and a number of other Asian countries. Moreover, a substantial fraction of SOE as well as collectives have liability asset ratios of 70 per cent or more. Nearly 10 per cent of all enterprises, and a greater portion of SOE, have ratios above 100 per cent, indicating that equity is technically negative.

Table 3- 6 Losses and Profits of Industrial Non- SOEs, 1978-2000

Year	*Losses (1978 prices in billion yuan)*	*Losses/gross profit (%)*	*Return on assets[a] (%)*	*Social Return on assets[b] (%)*	*Profit/sales revenue[c] (%)*	*Profit+taxes/ sales revenue[c] (%)*
1978	0.30	3.25	n.a.	n.a.	14.46	20.50
1985	0.72	3.77	n.a.	n.a.	10.64	17.05
1986	1.54	8.71	n.a.	n.a.	8.45	14.57
1987	1.88	9.79	n.a.	n.a.	7.65	13.31
1988	1.71	7.65	n.a.	n.a.	7.57	13.05
1989	3.14	17.32	n.a.	n.a.	5.72	11.16
1990	5.88	37.94	n.a.	n.a.	3.57	9.22
1991	5.72	31.08	n.a.	n.a.	3.80	9.04
1992	4.93	18.59	n.a.	n.a.	4.99	9.78
1993	7.41	19.17	6.65	10.81	5.32	9.95
1994	9.66	23.05	6.66	11.18	4.84	10.31
1995	16.21	36.58	6.47	10.27	3.65	8.19
1996	18.05	37.30	5.72	9.30	3.53	7.90
1997	21.36	37.21	5.34	8.85	3.63	8.07
1998	17.27	38.59	5.25	8.85	3.08	7.09
1999	15.00	27.80	5.53	9.18	3.83	7.79
2000	12.68	17.87	6.40	10.31	4.76	8.72

Note: a. Return on assets denotes "profit plus (net) financial charges, per unit of assets", where assets prior to 1993 comprise only average annual fixed-quota working capital plus year-end net fixed assets. 1993 assets are the sum of liabilities and equity. Net financial charges prior to 1993 are approximated as average annual interest rate on short-term (i.e. working capital) loans of maximally 6 months duration times total short-term borrowing (i.e. borrowing of less than 1 year maturity) by industrial SOEs; in 1993 the approximated value exceeds the actual value by 4.36 percent.

b. Social return on asserts denotes "profit plus taxes plus (net) financial charges, per unit of assets".

c. Sales revenue is net of all sales-related taxes.

Source: Carsten A. Holz (2002), Long Live China's State-owned Enterprise: Deflating the Myth of Poor Financial Performance", Journal of Asian Economics, Vol. 13, P498.

The deterioration in SOE performance appears particularly stark when viewed in terms of the incidence of loss-making firms. The proportion of industrial SOE incurring (after-tax losses) has risen from 31 per cent in 1994 to 42 per cent in 1997 and nearly 50 per cent in 1998[20]. Although a substantial number of enterprises in even very strong economies incur losses from time to time[21], the loss ratio for China's enterprises is quite high compared to most OECD countries. SOE are not alone in experiencing weak financial performances. As noted earlier, profit rates for collective enterprises as whole are also low by international standards. A high proportion of collective firms are also experiencing losses, although the fraction is only about half that of SOE. Urban collectives, however, appear to be doing significantly worse than the group as a whole (World Bank 1999). Liability-asset ratios are higher for collectives than for the SOE (see Table 3-6). Furthermore, the profitability of foreign-funded enterprises, while it has been substantially higher than that of the other segments, has fallen markedly: from 15 per cent of assets in 1995 to 4 per cent in 1996-1997 (World Bank 1999).

The pattern of declining profits and increasing incidence of losses for SOE as well as much of the non-state sector suggests a more general characterization: a large proportion of all enterprises, including the majority of SOE, are at best marginally profitable. That is, in addition to those making losses, a further significant portion of firms are making only small profits.

This impression is supported by results from an OECD statistical analysis with the assistance of the China National Bureau of Statistics (CNBS) in 2000. The analysis is based on a panel data set on the financial conditions of roughly 20,000 large and medium-sized industrial enterprises of all ownership types for the years 1995 through 1998 compiled by the CNBS[22]. The result of the analysis shows that the middle range of the distribution of after-tax profits (as a ratio of total assets and after deduction of corporate income as well as other taxes paid) of the full sample of enterprises is very close to zero. The situation for SOE is similar but worse, in the sense that their mean return is below the average for the entire group of enterprises. As these observations suggest, the marked increase in the incidence of losses since 1995 is partly the result of the migration of marginally profitable firms into the red. However, while losses of many unprofitable enterprises are fairly modest, the majority are large in the sense that the firms are incurring losses even before payment of their sales and other business taxes.

As discussed in the research, financial problems are significantly worse for some industries and regions than others but they are also quite pervasive. The incidence of SOE losses is noticeably above the industry average in textiles (which is the single biggest loss-maker) as well as several heavy industries including steel. SOE financial performances are also typically worse for central and western provinces than for those along the coast. At the same time, a large number of industries and regions are experiencing low or negative profit rates. While the worst performing industries account for a disproportionate share of total SOE losses, a substantial fraction of the losses are in relatively better performing sectors. This indicates that measures to restore the financial health of SOE need to be broadly applied: concentration on only the worst performing industries or regions will not be sufficient by itself.

All of these figures must be regarded with great caution. In particular, there are reasons to believe that official statistics significantly exaggerate SOE profits and understate their losses *(e.g.(Lardy 1998; Steinfeld 1998))*. Under the cash-basis accounting standards employed in China and most other developing countries, interest due on loans to enterprises that goes unpaid is not included in the calculation of profits and losses. Since, judging by the reported level of non-performing loans in the banking system, unpaid interest is sizeable, the biases in the reported profit and loss figures could be quite large. However, there may be some partially offsetting biases in the data. Costs of goods produced are attributed to the year in which they are sold and so inventory accumulation in a period of high inflation tends to overstate profits (Hussain and Zhang 1996). This overstatement should be smaller when inflation is low, as it is now, and to this degree the fall in profits since the early 1990s may be somewhat exaggerated. Moreover, there are incentives for firm management to appropriate profits that would otherwise go to the state and to exaggerate losses to obtain tax forgiveness and soft loans from banks (Zhang 1998), Hussain and Zhuang, 1996). The scope for such behaviour has probably increased as the result of reforms to increase management autonomy (World Bank 1997) and 1999).

As analyzed in the previous sections, the SOEs as a whole had seen a continuous decline in profits before 1998, but since the Chinese government launched a campaign to turn around the money-losing SOEs in three years 1998, officially reported at least, the performance of SOEs has improved in recent years. Profits have increased each year since 1998, to total RMB238.9 billion in 2001. Table 3-7 reveals that since 1998, the economic efficiency of SOEs has been improved, by the end of 2003, total assets to industrial output almost doubled from 6.52% to 10.09%, profit to industrial costs increased over four times, and also assets to liability declined from 64.25% to 59.24%. What's more, if we compare the efficiency of SOEs with other collective-owned and foreign-funded enterprises (see Table 3-8), we found that SOE efficiency has been much better than collective-owned enterprises.

By 2002, 52.5 percent of China's state owned and state holding enterprises have moved out of the red and into the black. According to the official statistics, of the 6599 large- and mid-sized SOEs and state holding enterprises losing money, 3463 have stopped losing money. SOEs from twenty-two provinces, autonomous regions and cities have already started to turn a profit while eight provinces' SOEs continue to lose money. Out of fourteen major industries, only the coal and military industries remain unprofitable. By the end of June 2002, the 519 major enterprises chosen by the State Council earned a total profit of 85.7 billion yuan, a 100 percent increase from last year. Money-losing SOEs decreased by 18 companies to 116. Losses dropped 22.3 percent. Money-losing SOEs lost a total of 8.22 billion yuan, down 19.8 percent.[12]

Turning around money losing SOEs on schedule would be good news for China's economy because it would provide a better environment for SOEs reforms. But there is another consensus in China's economic circles that is the "three year goal" is only a phase. There are many problems with the SOEs, such as bad debts, separating the government from the enterprise, injecting new management, etc, that have accumulated over the years, which remain unsolved.

The state's policies to reform SOEs have basically been put into effect. The SOEs will undoubtedly get less leeway from the state policies in the future. Although many policies such as the government setting up financial management companies to handle bad debts have helped SOEs a little, some of the trickier problems or vital reforms have been put off; many problems with the SOEs are a result of delaying reforms too long.

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[12] People's Daily, 2002. Beijing, China.

Table 3- 7 Economic Efficiency of SOE 1998-2003

(In percentage)

Year	*Total Assets to Industrial Output*	*Assets-Liability*	*Profits to industrial costs*	*Overall Labour Productivity*
1998	6.51	64.26	1.61	29054
1999	6.77	61.98	2.89	35741
2000	8.43	60.99	6.15	45998
2001	8.17	59.19	5.75	54772
2002	8.71	59.30	5.93	65749
2003	10.09	59.24	7.25	87095

Note: Figures refer to all industrial SOE with independent accounting systems.

1. Ratio of total assets to industrial output: total assets / gross industrial output. It reflects the profit-making capability of all assets of the firm and is a key indicator manifesting the performance and management and evaluating the profit-making potential of the firm.
2. Assets-liability: total debts divided by total assets. It reflects both the operation risk and the capability of the firm in making use of the capital from the creditors.
3. Profits to industrial costs: refers to the ratio of profits realized in a given period to total costs in the same period and as well the economic efficiency of input costs.

Source: China Statistical Yearbook, 2004.

Table 3- 8 Comparison of Economic Efficiency between SOEs and Other Firms

(Per cent of all firms)

Year	*Assets to Industrial Output*			*Assets-Liability*			*Labour Productivity*		
	SOE	COE	Foreign-funded	SOE	COE	Foreign-funded	SOE	COE	Foreign-funded
1999	6.77	10.39	8.46	61.98	66.62	56.45	35741	31577	79046
2000	8.43	10.98	10.52	60.99	65.59	56.30	45998	35581	89976
2001	8.17	10.93	10.74	59.19	64.24	53.91	54772	38916	98413
2002	8.71	11.77	11.30	59.30	63.54	53.73	65749	43556	106075
2003	10.09	12.76	12.71	59.24	61.46	55.43	87095	53168	123891

Source: China Statistical Yearbook, 2004.

Factors behind the worsening financial performances

A number of factors, rather than any single explanation, account for the poor performances of SOE as well as the growing problems of many non-state enterprises. The following can be cited as the main proximate sources of these problems:

- cyclical developments;
- imbalances created during the early 1990s investment boom;

- high debt burdens;
- policy-imposed burdens on SOE;
- chronic inefficiencies in enterprise operations, particularly of SOE.

However, in many cases these proximate causes reflect more fundamental structural weaknesses in enterprise governance and external discipline.

Cyclical developments, in particular the credit tightening in 1995-1996, the Asian crisis in 1997, and the resulting slowdown in economic growth have contributed to the decline in profit rates throughout industry. However, the impact on SOE has probably been modest, particularly given that the growth slowdown has been comparatively mild. Moreover, the downturn has been most pronounced for exports - due to the sharp fall in regional demand produced by the Asian crisis. This has led to a sharp reduction in profit rates for foreign-funded enterprises, but SOE should have been less affected.[24] The current growth slowdown does not explain why SOE profit rates were higher at the trough of the much sharper cyclical downturn in 1989-1990. Nor does it explain why those profit rates were falling through the first half of the 1990s, when real growth was considerably higher than now.

Imbalances created during the 1993-1996 investment boom very likely have been important contributors to the low profit rates throughout Chinese industry over the past several years. The boom left many industries with capacity utilization rates of 50 per cent or below and large overhangs of excess inventories that in turn have contributed to declining prices in much of the industrial sector since 1997. Although the overall impact is difficult to assess, the problems now being experienced by other Asian countries that underwent similar investment booms earlier in this decade suggest that the imbalances in China have been a major factor depressing current profits.[25] Over-investment in China and the resulting excess capacity are more fundamentally traceable to weaknesses in corporate governance and in external financial discipline. As in a number of Asian countries, the widespread availability of soft bank loans at virtually zero or negative real interest rates faced firms with a virtually zero cost of capital and resulted in strong incentives to maximise revenue by expanding capacity. In China, these incentives were reinforced by local government revenue needs and the policy imperative to maintain employment levels. The effects of the perverse external incentives were magnified by weaknesses in enterprise governance and management.

Indeed, reforms in the late 1980s probably made the situation worse by giving management greater autonomy to respond to the perverse incentives.[13]

The 1993-1996 investment booms also further aggravated the longer- term build-up in enterprise debt levels underway since the 1980s. High debt loads help to explain the large proportion of SOE that seem to be at best marginally profitable.[14] Debt service charges in 1999 averaged 4 per cent of total sales for SOE.[15] However the burdens are considerably higher for loss-making or marginally profitable enterprises. Nearly one-fifth of large and medium-sized SOE have debt-service burdens exceeding 10 per cent of their sales.[16] The high debt levels and their secular rise are largely due to the use of bank lending to make up for enterprise operating losses and other non-commercial objectives (practices partly attributable to the scarcity of government revenues for such purposes), and to the lack of alternatives to bank credit.

Policy burdens on SOE include surplus labour that enterprises are not free to shed, disproportionately high tax burdens, and expenses for social benefits such as medical care, pensions, housing, and education that go beyond the levels that enterprises typically provide in other economies. Higher tax rates on SOE compared to other enterprises are a further policy burden. SOE policy burdens are quite large and are a major reason why SOE profitability is low (Lin, *et al* 1998). For example, as indicated in the next section, surplus workers amount to a substantial portion of the employees of industrial SOE. Policy burdens are largely a legacy of prior central planning mechanisms but their persistence is substantially attributable to structural problems such

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[13] In such situation, the incentive is for enterprises to expand production, even in the face of excess capacity in the industry at large. Since capital is virtually free, losses can be covered by new bank loans, and production even if unprofitable, still serves to cover part of the wages of workforce.

[14] Since the debt ratios, as well as interest rates, have fallen, they do not explain the fall in profit rates since 1996.

[15] The 1999 figure is from published data reported by the China Economic Information Network, March 9 2000.

[16] The figure is derived from the OECD analysis. The figures from that sample put financial charges of large and medium-sized enterprises at 4.9 percent of sales, somewhat higher than the text figure for all SOE for 1999.

as the lack of socialized social benefit programmes and (again) the scarcity of government revenue.

A rough but useful further illustration of the importance of these policy burdens can be obtained by comparing profits on sales (sales revenue less expenses directly related to production) to pre-tax profits (which deduct overhead costs not directly related to production) and then to after-tax profits (Ash and He 1998). Virtually all these profit measures have declined during the 1990s for all types of enterprises. However, sales profits, as a share of gross output, have been consistently higher for SOE than for non-state enterprises as a whole. The pre-tax profit rate is also higher for SOE, but the gap between the enterprise classes is somewhat narrower than for sales profits. The gap is reversed once taxes are deducted, with the after-tax profit rate for SOE less than half that for non-state firms.[17] This pattern is especially pronounced for enterprises with relatively high total factor productivity and reflects the fact that the SOE tax burden is concentrated on the most productive and profitable enterprises in this group. These comparisons confirm that policy burdens are a major factor behind the lower profitability of SOE compared to non-state enterprises.

Finally, it has been argued that, as the legacy of past central planning and years of poor governance, SOE suffer from chronic operating inefficiencies that would severely impair their profitability even if their policy burdens and heavy debt loads were alleviated. These chronic operating inefficiencies arise from poor organization, inefficient and obsolete productive capacity, outmoded technology, and low product quality. For example, the average size of SOE operations in key industry segments, particularly heavy industry, is low by international standards. Technological backwardness is also a major problem impairing the operating efficiency of many Chinese enterprises. As discussed further in the next section, much of the equipment used is relatively old, and research and development spending by SOE is low and

[17] Taxes paid by SOE are more than twice as large in relation to their gross output as those paid by other firms. This situation reflects a long-standing policy to use SOE as the major revenue source for central and local authorities, while promoting development of non-state enterprises through preferential tax treatment. Foreign joint ventures have been particularly favoured in this regard with tax exemptions and other preferences applied within the special economic zones.

declining. Aggregate data appear to confirm the impression that SOE are relatively less efficient than comparable non-state enterprises. In particular, the portion of SOE industrial employment in firms with relatively low measured total factor productivity is about twice that of collectives. A recent study of the World Bank with the CNBS suggests that a significant portion of large and medium-sized SOE, accounting for 11.6 per cent of total industrial SOE employment, have total factor productivity levels that are either negative (meaning that enterprise revenues are insufficient even to cover their wage costs) or too low for competitive viability (World Bank, 1999).

It has been suggested that chronic operating inefficiencies are so wide-spread among SOE that the majority, if not most, would not be competitively viable even if their policy and debt burdens were alleviated. However, at least two considerations suggest that this impression is exaggerated. First, evidence also points to a substantial segment of SOE that appear to be relatively efficient and competitive. The figures derived from the World Bank/CNBS study indicate that SOE accounting for 78 per cent of value-added and 39 per cent of total employment have total factor productivity that is at least adequate (World Bank, 1999). Second, average productivity figures such as those quoted above very likely overstate the extent of chronic efficiency problems in the SOE sector. In particular, firms that are otherwise efficient but forced to carry large numbers of excess workers are likely to exhibit low measured factor productivity even though they would be more competitively viable if the excess labour could be shed. Given the substantial portion of excess workers in relation to total employment, the resulting understatement of SOE productivity could be quite substantial. Moreover, chronic operating inefficiencies are not confined to SOE but are also probably widespread among collective enterprises – although their full extent is again not known.

On balance, it appears that much of the decline in profitability of SOE since 1995 can be attributed to the combined effects of the excess capacity created during the prior investment boom and subsequent slowdown in aggregate real growth. Policy and debt burdens are major factors, possibly the most important contributors overall, to the low level of profitability of SOE as a whole and to the high incidence of loss-making firms. High debt burdens are also an important factor behind the low or negative profitability of many collective enterprises. The extent of these problems differs considerably across ownership classes, industries, as well as individual firms. A major challenge in this regard is to identify the extent of chronic operating inefficiencies of firms which, because of policy burdens or other factors, have been unable to operate as efficiently as they are technically capable.

3.3. Privatization and Restructuring of SOEs

Restructuring and privatization are now widely seen as important instruments of government policy for creating appropriate conditions for enhanced economic growth and for redefining the role of the State. More than 100 countries in every continent have in recent years embarked on projects to privatize and restructure their state-owned enterprises (SOEs), including Argentina, Chile and Mexico in Latin America; Malaysia, Pakistan and the Philippines in Asia; the United Kingdom and France in Western Europe and the transition countries of Central and Eastern Europe; as well as Côte d'Ivoire, Nigeria and Togo in Africa. Some industrialized countries, including New Zealand and the United Kingdom, and several developing countries, such as Argentina and Mexico, have pursued privatization programmes that are both radical and ambitious in their scale and scope.

What kind of privatization program is best suited to stimulate enterprise restructuring in former centrally planned economies? One view, expressed by most Western business and political leaders, is that privatization is best pursued case by case, with emphasis on sales to new owners, including foreign investors. Another view, espoused by a minority of radical economists and economists-turned-politician, was that restructuring is best pursued through economic incentives, combined with mass privatization of state enterprises so that they become widely held (public) joint stock corporations. For example, some of the Eastern European countries that have pursued mass privatization most actively and credibly, have also done best in restructuring its industries and reorienting them toward world markets. Hungary, for example, has followed the gradual, case-by-case approach; the Czech Republic and Russia have relied on mass privatization. In Poland, mass privatization has been held up for nearly four years.

Privatization and restructuring of the SOE sector is intended to concentrate state ownership and control on a core of large enterprises in strategic industries while withdrawing state ownership and support from small and medium-sized enterprises.

SOE restructuring is closely linked to the economic restructuring of the enterprise sector as a whole and to corporate governance reforms. Creation of the strategic core of large SOE involves their conversion into modern enterprises and the formation of large enterprise groups that will be able to compete against large foreign multinationals. These groups face important challenges in overcoming the present problems of their SOE and in sustaining the efficiency and flexibility that will be needed to compete successfully in international markets.

The withdrawal of state control from SOE outside the strategic core does not amount to wholesale privatization along the lines pursued in European transition economies. The majority of medium and smaller SOE are being transferred to insiders and converted into co-operative or other ownership forms that are intermediate between public and private ownership. Economic performances of these enterprises have so far been mixed and their structures are likely to continue to evolve.

The overall purpose of SOE privatization and restructuring is to establish state enterprises as commercially viable entities in those industries where continued state involvement is seen as necessary to the longer-term development of the economy. The specific objectives are to transform SOE into modern corporate enterprises, concentrate their activities, improve their economic performances, reduce their burdens on government finances, and enhance China's ability to compete with foreign multinationals in international markets. In these respects, SOE restructuring is both complementary and closely related to economic restructuring of enterprises and to corporate governance reforms. SOE restructuring is similar to the privatization programmes of FCE countries during their transitions in that it involves large scale reallocation of assets from the state to non-state sectors. However, it differs from the European programmes in two key respects: first, SOE will remain more important in the overall economy; and the exit of firms into the non-state sector does not amount to their wholesale privatization.

Starting in the early 1990s, authorities began to experiment with reforms to SOE control structures that have now become a key element in the SOE privatization and restructuring strategy. The current phase in privatization and restructuring was officially launched by the *Decisions on Issues Related to State-Owned Enterprise Reforms and Development* issued by the 15th Party Congress held in September 1997. In addition to restating the principle that the state and state ownership would continue to have a major role in the economy, the Party document defined three specific principles governing the strategy of SOE restructuring.

- China is a "mixed" economy in which a variety of ownership forms, including private ownership, co-exist.
- The state will retain full control of defence industries and the dominant position in "strategic" industries deemed critical to economic development.

State ownership will be progressively divested in other ("competitive") industries. Ownership in these industries will be broadened through a variety of means, and private stakes in even large enterprises will be allowed in principle.

The latter two principles are typically summarized as "grasp the big" while "release the small" (*Zhua Da Fang Xiao*); and transforming the distribution and structure of state owned assets (*Zhan Lue Tiao Zhen*). "Seize the large" means that state ownership will ultimately be restricted to large SOE in the strategic industries. Although they have not yet been fully identified, these industries are expected to include all or most of: utilities, energy, natural resources; transportation and other major infrastructure; and industries requiring very large-scale investment projects, such as steel, ship building, and petrochemicals.[51] Certain key services, such as grain distribution, finance, and some foreign trade activities are also likely to remain under state control. However, while the state will retain the controlling interest, ownership of SOE in strategic industries is to be diversified to allow non-state (including foreign and private) equity shares. State ownership in the "competitive" industries is to be progressively withdrawn and ultimately curtailed.

While reflective of the status quo, the first principle represents the first official acknowledgement of the legitimacy of non-state ownership in industry. It also allows in principle for private ownership in sectors previously reserved for SOE, including private equity stakes in even large SOE. The status of the private sector was further strengthened in March 1999 by the Ninth National People's Congress, which approved a constitutional provision upgrading the non-state sector from an "important complement" to a state dominated economy to an "essential component" of a mixed economy.

While the *Decisions* made a clear distinction between large, strategic SOE and small SOE, the treatment of medium-sized enterprises remained somewhat ambiguous.

In 1999, however, the formal decision was taken to withdraw state control from medium-sized SOE. Under these plans, the number of industrial SOE is expected to fall from the existing nearly 75,000 to at most one or two thousand.

The complete transformation of the SOE sector is envisaged to extend through the current decade. Much of the conversion of SOE into corporate entities is supposed to be completed by 2005. Completion of the programmes to establish large enterprise groups and to consolidate industries is not expected before 2010.

3.3.1. Formation of the SOE Core

The transformation of the large SOE into commercially viable entities has become the major objective of recent SOE reform under the programme of establishing a "modern enterprise system". Three complementary modalities are being used to create the strategic core of large SOE that will remain under state control. These modalities are: corporatization; ownership diversification; and formation of large enterprise groups.

Corporatization

Under the pre-reform central planning system, Chinese SOE existed as an integrated part of government departments. Although early reforms attempted to dilute the ties between the government and the SOE, Chinese SOEs have remained closer to government agencies than to commercial business entities in terms of their control structures. The major problem arising from this arrangement has been the ambiguous property rights and ownership of the SOE, as the assets of the SOE are subject to the control of a range of government departments or agencies but ultimately belong to no one in particular (although in principle the SOE assets belong to the Chinese people, they do not have direct control rights). The "corporatization" programme is an attempt to clarify property rights of SOE by making them separate legal entities with a defined sphere of autonomy. The overall objective is to transform SOE into "modern corporate enterprises" with commercial objectives and clearly defined rights and obligations under the law, so that they can be held accountable for their performance. This "corporatization" process is seen as a necessary precondition for the creation of the strategic core. It entails separating government functions from enterprise operations and allowing the introduction of governance mechanisms that establish accountability of management to the enterprise's owners (the state). Corporation is also a necessary step to introduce diversified ownership of the SOE as well as to list them on domestic and foreign stock exchanges.

Efforts to transform large enterprises into corporate form began in the early 1990s. The enactment of the Company Law in 1993, which became effective in July 1994, provided the national legal framework. This framework provides for SOE to become either limited liability companies (LLC) or joint stock limited companies (JSC), *i.e.* limited by shares. By the end of 1999, more than 7,000 medium and large SOE are estimated to have been corporatized. Among the 2,562 large SOEs that were selected for the original pilot programme, more than half became JSC while another 28% became wholly state-owned LLC. This transformation is accompanied by the implementation of the structures mandated by the Company Law for ensuring effective corporate governance, such as the shareholders' general meeting, the board of directors and the supervisory board.

Ownership diversification

"Ownership diversification" has become the chosen modality of ownership restructuring for larger corporatized SOE in China, in contrast to the wholesale privatization pursued in European transition economies. In China's context, ownership diversification for large SOE has meant the encouragement of shareholding among various state entities. While non-state interests are allowed in principle, their role has been only limited, although as indicated below, it is now increasing. The introduction of multiple ownership is intended as a way to sever more fully the direct ties between a SOE and its controlling authority; and to encourage a more commercially oriented operation of corporatized firms by subjecting them to the checks and balances of multiple shareholders.

Ownership diversification has been part of the SOE restructuring strategy since the early 1990s but, until recently, it has been largely limited to encouraging multiple ownership through the cross-shareholding among various state institutions such as provincial and local governments, local state asset management companies or other SOE. As a result, state ownership has dominated even the listed companies, with about 70 per cent of the shares of the listed companies held by the state as of 1999. The scope for further expansion of non-state interests in SOE has been substantially limited by two provisions governing share listing. The first is the legal requirement that the state directly hold a minimum of 35 per cent of the shares of listed SOE, these shares cannot be traded on the stock exchanges. The second stems from restrictions that largely prevent the trading of shares held by other entities under state control ("legal person shares"). As a result, in practice, only about one-third of a companies" shares have been actively traded. However, the scope for diversification of SOE ownership among different state owners *(e.g.* state asset management companies controlled by various localities) is somewhat greater, at least potentially; and could provide at least some of the benefits that broader diversification is intended to achieve.

More recently, ownership diversification through the participation of non-state investors has been given increased emphasis. It was most recently endorsed by an official statement in September 1999 that "effective methods of public ownership" will be reinforced through "mixed forms of ownership".[18] Under present plans, ownership of SOE remaining under state control will be broadened to include minority stakes by private, foreign, or other non-state investors. The recent drive for further ownership diversification through the stock markets has been motivated by two main factors. First, it is seen as a means to expand SOE equity, thereby providing funds for investment and to reduce SOE debt burdens. At the same time, participation of outside shareholders is seen as a vehicle for the much needed improvement in corporate governance of large SOE. The pressing financial needs of social security programmes have provided another motivation for relaxing restrictions on holding of state shares. In late 1999, authorities announced plans to sell a further portion of state equity in SOE.[57] It was subsequently announced that the capital raised by the sale would be used to fund the pension system. In part to facilitate these sales, authorities announced plans, in June 2000, to relax restrictions on the trading of directly state-owned shares.

There have also been signs that restrictions on the majority or full ownership of SOE by foreign or private capital are being relaxed. For example, the provincial government of Guangdong announced that it would allow private enterprises to wholly acquire the state-owned power plants, which are affiliated with the Provincial Power Bureau. In addition, private capital is being allowed to participate in investment in some

[18] Statement of the Fourth Plenum of the 15th Central Committee of the Chinese Communist Party, held in September 1999.

infrastructure projects, such as roads, bridges, information service sector projects and sewage disposal facilities. In a rare move, the authorities also allowed one foreign company to purchase 100 per cent of a state-owned carbon plant in the Northwestern Ningxia Autonomous Region.[19] Although this move might have been primarily driven by the desperate need for outside capital in an inefficient plant located in a backward region, it may indicate increased flexibility in the terms that local authorities are willing to offer to potential investors. At the same time, other cities including Wuhan, Chongquing, Beijing, Shanghai and Tianjin have announced that licences for solely state-owned firms would no longer be given in their industrial sectors. The authorities in these cities also intend to promote diversified forms of ownership through measures such as withdrawing all or part of state capital from SOE and encouraging private companies to merge with and to restructure SOE.

Large enterprise groups

Another modality of the current reform strategy to create the SOE core is the formation of large enterprise groups (EG) modelled after Korea's conglomerates (chaebol). Chinese EG were first established at the beginning of the reform period as horizontal associations among SOE controlled by provincial and local governments. The original purposes of the groups, which often spanned several industries and localities, were to increase supplies of key products, facilitate specialization in production, and to help co-ordinate economic activities among regions. In the process, they helped to offset the effects of regional barriers to trade and factor mobility. These groups have subsequently expanded greatly through a largely spontaneous "bottom up" process involving joint ventures and a variety of other business arrangements (Lee 1999b). By the late 1990s, there were nearly 2300 of these enterprise groups throughout industry, many of them highly competitive and profitable (Ding 1999).

Beginning in the early 1990s, authorities began to establish large EG from central government-controlled SOE. As with the earlier groups, these EG typically include firms in a number of industries and regions, but they are generally much larger and they have been formed through a top-down process directed by government

[19] Elkem, a Norwegian light metals group, agreed to acquire full ownership of Ningxia Shizuishan No. 1 Carbon Plant (Financial Times, 7 June 2000)

authorities. Their establishment was motivated by the increasing competition the enterprises were facing in domestic markets from enterprises funded by foreign multinationals.[60] Formation of the large EG is being pursued to achieve the scale, scope, and diversity of operations that authorities see as necessary to allow China's industries to compete with foreign multinationals in domestic and international markets.

Large enterprise groups were given a central place in the effort to establish the strategic core of SOE industries following the 15th Party Congress in 1997. The government gave preferential treatment to enterprise groups in credit access, support for technical upgrading and listing. Some of the enterprise groups are sector specific, while others are conglomerates that control companies in several industries. The number of EG has grown from 57 groups in 1991 to 120 groups directly under the central government in 1997. Together, these groups controlled 1.6 trillion yuan in assets (US$ 192.7 billion or about 5 per cent of the assets of all large industrial SOE) and had total sales of 931 billion yuan (US$ 112 billion) (see Table 3-9).

Table 3- 9 General situations of pilot enterprise groups in selected industries

Type of industry	*No. of groups*	*Total assets* (billion yuan)	*Net assets* (billion yuan)	*Sales income* (billion yuan)	*Profits and taxes* (billion yuan)	*Export income* (billion yuan)
Metallurgy	8	35.7	19.2	17.8	2.8	228.0
Energy	11	41.3	20.3	14.7	1.7	30.9
Chemical	7	7.7	2.9	3.5	0.5	25.5
Automobile	6	26.3	9.0	21.9	2.4	42.1
Machinery	14	4.4	1.3	2.5	0.3	26.2
Electronics	10	4.3	1.5	4.3	0.4	103.6
Transportation	8	23.4	8.1	10.3	0.6	256.1
Pharmaceutical	5	3.9	1.3	2.4	0.3	31.4
Construction	3	15.5	3.1	10.7	0.5	48.3
Foreign trade	8	11.9	2.3	13.6	0.3	764.7
Average of 120 groups		13.4	5.4	7.8	0.7	117.3

Note: Figures refer to enterprise groups controlled by the central government.
Source: Shen (1999).

The economic performance of enterprise groups has been somewhat mixed. In some cases, the groups have attained their goals for improved competitiveness and expanded business. Some of the groups have become strong competitors in international markets. However, many enterprise groups have experienced a decline in the competitiveness of their companies. As in other countries, "big" has not always been a guarantee of "better".

Several reasons can be cited for the problems of these enterprise groups.

Weaknesses in their corporate governance mechanisms. Many groups were formed before they were fully transformed into corporate entities, and government agencies have continued to be involved in their management. Partly as a result, the groups have often been insufficiently flexible to meet changing market demands.

Weak financial discipline coming from implicit government backing. Given their important ("too-big-go-fail") role in the economy, the government has been reluctant to allow large loss-making EG to go bankrupt and thus has continued to provide bailout loans to those on the brink of bankruptcy, as was the case in Korea before the financial crisis (OECD, 1998*c*). In this situation, the managers of large EG have little incentive to improve productivity or profitability, thereby increasing the burden on public finance.

Formation of groups by government fiat with insufficient attention to their economic merits. As with government directed M&A, the top down process gives at best limited weight to the economic motivations ("culture") or expertise of the management of the individual enterprises. Moreover, as the larger firms are frequently asked to absorb smaller, debt-ridden firms, the potential economic benefits in terms of profitability or efficiency are questionable.

Formation of groups to obtain preferential policies from the government. In such cases, longer-term economic efficiency tends to become a secondary consideration in the formation of the group.

3.3.2. Privatization of SMEs

The disengagement of the state in SMEs in the state and collective sector has occurred in various ways. On the principle of "grasping the big and releasing the small", local governments were empowered to choose how to reform state and collective SMEs. The exit ("divestiture") of small SOE from state control and responsibility was first officially endorsed by the Third Plenary Session of the 14th Party Congress in November 1993, but pilot programmes organized by the central government and initiatives undertaken by local governments were already in place a few years earlier. Following the official decision, local governments quickly embarked on programmes to privatize and divest their small SOE. The emphasis has been on the divestiture of loss-making firms, in order to reduce the burden on local governments of supporting their workers. Divestiture of smaller SOE is part of a broader process of ownership transformations underway in the business sector, including the extensive conversion of TVE into joint-stock co-operatives (Chai 1997; Clarke and Du 1998; Li, Li, and Zhang 1998). A large portion of TVEs have become effectively privatized under this process, although in many cases they remain officially registered as collectives.[20] The objectives are similar in both cases: namely to reduce government burdens and responsibilities for public enterprises, while improving their capabilities to successfully compete in a market environment.

Since 1994, China has closed or bankrupted 3,080 companies, written off 199.54 yuan to account for non-performing loans, and relocated to new jobs 5.3 million workers once worked in SOEs. 80 percent of Small and medium-sized state enterprises at country level and 60 percent at municipal level had been privatized (Collier 2003).

A number of modalities are being used to move small and medium-sized SOE out of state control and responsibility. These include: restructuring of the existing operations; formation of business alliances with other firms; M&A; transformation into leasing companies or contract operations; formation of "joint-stock co-operatives", *i.e.* enterprises owned by their workers and management, and outright sale to outsiders (Table 3-10). Some of these modalities involve conversion into legally private enterprises, while others, notably the joint-stock co-operatives, do not. The predominant pattern has been divestiture to "insiders" in which existing management is largely retained, although as indicated below there are important differences in this respect among regions. While, in principle, transformations are subject to strong requirements on employment and compensation for separations and debtors' claims, in practice these conditions are less strict. Enterprises and employees are free (in principle) to choose the form of transfer, but conversion of SOE into shareholding co-operative enterprises have been the most prevalent modality, particularly in industry. Creation of legally private enterprises from former SOE has been predominant only in retail and other service sectors where the average size of firms is quite small.

[20] International Finance Corporation (2000), "China Private Enterprise Study", Nico Howson, April 26.

Table 3- 10 Transformations of SMEs by 2000

Region	*No. of firms*	*Trans-formed (%)*	*Method (%)*							
			R	*M*	*L*	*C*	JSC	*Sale*	*B*	*Other*
Coastal	17,629	83	17	13	11	9	22	8	8	12
Central	20,713	83	14	11	14	9	22	9	11	10
West	21,068	80	20	12	9	8	19	9	11	12

Notes: R-restructuring, M-merger, L-leasing, C-contracting, JSC-joint-stock company, B-bankruptcy.
a. Liaoning, Hebei, Beijing, Tianjin, Shandong, Jiangsu, Shanghai, Zheijang, Fujian, Guangdong.
b. Heilongjiang, Jilin, Shanxi, Henan, Hubei, Anhui, Jiangxi, Hunan, Hainan.
c. Inner Mongolia, Shaanxi, Ningxia, Gansu, Qinghai, Xinjiang, Tibet, Sichuan, Guizhou, Yunnan, Guangxi.
Source: State Economic and Trade Commission, Beijing, China.

Divestiture by these modalities has proceeded quite rapidly since 1996. According to estimates prepared by the SETC, as much as 80 per cent of small SOE had been converted into one of the above forms by the end of 1998; although the number of enterprises formally transferred into the non-state sector seems to be substantially less . Regionally, the coastal and southern provinces were reported to have transformed almost all of their smaller SOE by the end of 1998, while many North-eastern provinces had also made significant progress. For example, Liaoning province, a heavy-industry centre in the northeast, had shed at least 60 per cent of its smaller state companies, while Hubei province in the middle of China divested about 84 per cent of their smaller SOE.

Various factors have contributed to the differences in the pace and modalities of small SOE divestiture among provinces. First, the central government did not set clear rules on the method of transfer, so local authorities have been left to formulate their own criteria and procedures. Second, local financial conditions played a role. Provinces that have long been plagued by huge losses of their SOE and limited government financial resources have had strong incentives to divest their small SOE as rapidly as possible. These provinces have given more emphasis to outright sales and other modalities entailing little or no further assistance from local authorities. On the other hand, wealthier areas with a relatively low incidence of loss-makers and more rapid economic growth have placed less emphasis on sales to outsiders. In Shanghai municipality, the strategy has been to "support the small" SOE by facilitating their restructuring.

The performance of divested small SOE has been mixed. Some have become profitable within a short period.

Other firms are finding it difficult to survive without state support. With no local government guarantees and increased stringency of bank lending standards, poorly performing small SOE are generally unable to obtain bank loans. Moreover, many SOE continue to be burdened by inefficient equipment, outdated technology, and poor management that impaired their performance under state control.

The divestiture process suffered an apparent setback in mid-1998 following growing reports of widespread asset stripping and other abuses by SOE managers. In addition, to make companies more attractive for sale, local authorities had written off at least 100 billion yuan in debt without consulting the creditors. In response to these problems, the central government in July 1998 ordered local governments to exercise increased care in transforming small SOE and to slow the pace of divestiture. However, the actual pace does not seem to have slowed greatly; while continuing to divest their SOE, local governments apparently under-reported their extent to central government authorities.

There have been important recent developments that signal further broadening and deepening in the letting-go process. The most important of these was the decision in 1999 by the National People's Congress endorsing the divestiture of medium-sized SOE. This decision provides the official sanction for provincial and local governments to begin transforming their medium-sized SOE along the lines that have been applied to the small SOE. Most of medium-sized SOE will be transformed into joint stock co-operatives or contract management firms (rather than privatized) and the process is expected to be largely completed within the next five-year plan. The Shanghai municipal government has announced plans to sell 101 industrial companies (ranging from textile firms to fire-fighting equipment producers) worth 744 million yuan (US$ 90 million) to foreign investors.[21] The city of Shenzhen plans to phase out state ownership of all its enterprises over the next five years to eight years, including its large SOE.[22] The Nanjing municipal government has also announced its plan to withdraw 80 per cent of the state shares from small and medium-sized SOE by the end of 2000. The city of Wuhan is promoting divestiture of its small and medium-sized SOE through the sale of shares to employees or other individuals. Under the new policy, employees can

[21] Zhonghua Gongshang Shibao (Business Times, 16 June 1999)

[22] Zhongguo Xinwen She (China News Service, 8 July 1999)

buy shares in state assets through cash or with proceeds from special loans for the purpose; they may also receive shares in lieu of their normal compensation, or through conversion of their interests in benefit funds. A number of other localities are also implementing pilot privatization projects involving employee ownership of the shares of the small and medium-sized enterprises.

3.3.3. The Changing Role of Government in SOE Restructuring

Large-scale and aggressive SOE restructuring carried out in China since the mid-1990s is one of the most daunting challenges faced by economic policymakers. The government is forced to take a leading role, even if indirectly, because of the need to prioritize policy goals, address market failures, reform the legal and tax systems, and deal with the resistance of powerful interest groups. The objectives of large-scale corporate restructuring are in essence to restructure viable firms and liquidate nonviable ones, restore the health of the financial sector, and create the conditions for long-term economic growth.

Stone (2002) argued that successful government-led corporate restructuring policies usually follow a sequence. First, the government should formulate macroeconomic and legal policies that lay the foundation for successful restructuring. After that, financial restructuring must start to establish the proper incentives for banks to take a role in restructuring and get credit flowing again. Only then can restructuring begin in earnest with the separating out of the viable from nonviable firms -restructuring the former and liquidating the latter. The main government-led corporate restructuring tools are mediation, incentive schemes, bank recapitalization, asset management companies, and the appointment of firm directors to lead the restructuring. After achieving its goals, the government must cut back its intervention in support of restructuring.

Choosing the Form of Government Involvement

Experience has shown that large-scale corporate restructuring requires the government to take a leading role so as to establish priorities, limit the economic and social costs of crisis, address market failures, and deal with the obstructions posed by powerful interest groups. The government's role in corporate restructuring is highly country-specific owing to its complexities, social consequences, and involvement of different elements of society. Thus, there are relatively few overarching operational principles or obvious ways to organize the policy choices, especially in comparison with other structural policy areas such as capital account liberalization and labour market reform. The approach taken here is to examine five government-led corporate restructuring methods in ascending order of government involvement.

Government mediation

Government mediation between corporations and banks or between banks is warranted if creditors are unwilling or unable to lead corporate restructuring. Reasons may include a lack of bank capital, excessive negotiating power by either debtors or creditors, or a lack of incentives for banks or corporations to work out debt problems. These factors can prolong restructuring and result in avoidable costs and even the unnecessary liquidation of debtors. To avoid these pitfalls, the government can mediate informally or in a more structured framework. The best known form of official mediation is the "London Approach," which is implemented in the United Kingdom under the aegis of the Bank of England.

The government mediation framework is appropriate if corporate restructuring is limited in scope and the environment supportive. This approach offers flexibility and adaptability, but requires a credible government mediator, macroeconomic stability, and the appropriate regulatory setting - all of which are attributes of the United Kingdom where the London Approach has been successful. This approach has proven to be less useful when there are a great many creditors, especially foreign creditors.

Government-financed incentive schemes

Financial incentives through a preset government-financed scheme can help if corporate distress is systemic, market or regulatory failures inhibit restructuring, and the government has adequate fiscal resources at hand. These schemes usually involve insurance or subsidy incentives made available to creditors and debtors on a voluntary basis. Incentives include compensation to creditors for lengthening debt maturities and grace periods, interest rate and exchange rate guarantees, and equity injections. The government must trade off the fiscal costs of the plan against the systemic benefits of alleviating corporate distress. Government strategies were employed by Mexico in the early 1980s and in the mid-1990s, and Chile.

Recapitalizing banks

Bank recapitalization is warranted if corporate debt problems are pervasive enough to undermine the health of the banking system, and if banks are willing and able to restructure corporations on their own. The widespread interruption of corporate loan payments, which usually reflects macroeconomic instability, will reduce and can even wipe out bank capital. If new capital is all that banks need to restructure debt (that is, they have the incentives and capacity for working out loans), and if new private capital sufficient to restore the banks to normal operation is not forthcoming, then public financing is needed to restore bank capital.

A new bank-restructuring agency is typically established to help coordinate the policies needed to ensure the success of recapitalization. The agency must gauge carefully the potentially large fiscal costs of bank recapitalization against the benefits. Existing shareholder equity should be written down before public funds are used to recapitalize banks to ensure that taxpayers do not bear more than their fair share of the burden. Requirements for the restructuring agency to unwind its equity positions upon the meeting of pre-specified conditions accelerate the return of banks to private control. Finally, the agency in most cases will play a key role in deciding whether banks should manage their own impaired assets or spin them off into an asset management corporation or other entity.

Recapitalization costs tend to be higher than for the average banking sector crisis, given the severity of systemic financial crises examined here. Bank resolution costs in a typical bank crisis tend to be equivalent to about 7 14 percent of GDP, but in Indonesia it reached more than 50 percent and in Chile 41 percent.

Bank recapitalization is warranted under similar conditions as for government schemes but where banks are better qualified to work out debt. However, recapitalization creates a fresh "moral hazard" problem: that is, banks may have incentive to gamble the new capital on risky loans with the expectation that they will again be recapitalized if these loans do not pay off. Further, newly recapitalized banks holding large equity shares in restructuring corporations may face conflicting objectives. To avoid moral hazard, recapitalization should be complemented by measures that improve bank supervision and governance, especially if banks end up owning a large share of the corporate sector. Tying bank recapitalization to specific bank measures to restructure corporate debt can be helpful.

Asset Management Corporation

A new government-financed asset management corporation is called for if the number of troubled corporations is large and there are microeconomic elements that severely inhibit restructuring. The most important of these are recapitalized and poorly managed banks, a shortfall of bank debt workout expertise, an uneven balance of power between banks and corporations, a lack of corporate capacity and willingness to provide reliable financial information, and, again, adverse systemic consequences. A government-financed asset management corporation can buy bad loans, provide equity to banks and corporations, negotiate with debtors, and take an active financial and operational role in restructuring. If bankruptcy courts are ineffective an asset management corporation can also serve as an out-of-court bankruptcy mechanism, since the passing of legislation and the building of institutional infrastructure for effective bankruptcy procedures can take time. The debt taken on by the asset management corporation can be converted to equity and eventually sold to the public. The asset management corporation realizes economies of scale in the specialized area of corporate debt restructuring and can develop secondary debt markets. Banks benefit from higher capital, while corporations can expect to have their debt restructured more quickly.

Asset management corporations were used in Hungary, Indonesia, Korea, and Malaysia. In East Asia, asset management corporations have taken on large amounts of debt, ranging from the equivalent of 10 to 35 percent of GDP. However, disposal and resolution of the assets have proven to be quite slow. An asset management corporation is appropriate if bank-led debt restructuring is unfeasible, but it also has risks. To be successful, an asset management corporation should have clear and predefined goals and aim to maximize loan recovery, remain clear of politicization, and be sufficiently funded.

Restructuring director

The complexities of the corporate and financial restructuring efforts of many of the recent corporate crisis countries have led to the appointment of a restructuring director to accelerate the pace of reform. A director can clearly and transparently define the goals of restructuring, overcome excessive leverage by creditors or debtors, marshal and prioritize government financial support, and establish a place at the table for elements of society that might otherwise be excluded. Typically, restructuring directors are appointed by and report to the country's chief executive and oversee mediation efforts, corporate restructuring committees, asset management corporations, and the bank-restructuring agency.

Restructuring directors are a relatively recent development. None of the crisis episodes of the 1980s and early 1990s appear to have had such a director. In Korea, financial restructuring was directed after early 1998 by the Financial Supervisory Commission. The Commission's chairman was a member of the cabinet and reported to the President.

A restructuring director can help accelerate the pace of restructuring when there are a large number of players with conflicting interests and systemic consequences increase the costs of delays. Naturally, there are potential problems with centralizing supervision of restructuring, including excessive politicization and the absence of market incentives to guide decision making. However, as restructuring becomes ever more complicated and the systemic consequences of corporate crisis remain severe, directors may become a more regular feature of large-scale restructuring efforts.

Reducing the Role of Government

The need for the government to first expand and then shrink its role helps explain the long time needed to complete restructuring. The new restructuring institutions are subject to economic and political constraints that force the government to weigh difficult tradeoffs, especially between restructuring's short-term costs (unemployment, dramatic falls in asset prices, learning curve of new corporate managers, for example) and long-term benefits (improved resource allocation, and safer balance sheets). Initially, the crisis atmosphere quells disagreements between interest groups brought on by unemployment and the removal of corporate owners. However, after the crisis passes and economic activity recovers broad support for reform often wanes. Crucially, the influence of vested interest groups can delay bankruptcy reform and privatization that would dilute their ownership.

The completion of restructuring is marked by the sale of most or all of the government's ownership of the private sector, which can grow to large levels after a crisis. Government ownership of the corporate sector can be direct - after the conversion of debt into equity - or indirect via government-owned asset management corporations and government recapitalization of banks. Successful privatization requires a transfer of control not only from the government, but also from current management. The introduction of a strategic investor who, in a small or medium-sized economy, is likely to be a foreign financial institution is usually needed to improve corporate governance.

The successful completion of large-scale corporate restructuring can often take a long time-a minimum of perhaps five years. In Chile, the initiation of restructuring can be marked by the takeover of ailing financial institutions in late 1981, while the last takeovers and debt restructuring programs took place in 1986; the bank privatization and upgrading of the institutional framework was not finished until 1989. By 1998, government ownership of banking sector capital in Poland had been reduced to one-third and foreigners owned 40 percent of bank capital, while for Hungary government ownership was down to 20 percent, with most of the remaining share owned by foreigners.

Delays in restructuring can be costly. The perpetuation of government ownership can inhibit restructuring and long-term growth prospects by obstructing the market forces needed to promote efficiency. In addition, a slow pace of restructuring will lead foreign investment to other, competing countries - a process that may be difficult to reverse. Finally, there are fiscal costs to delaying restructuring especially from inefficient state-owned banks and corporations.

The time needed to complete restructuring can be shortened if the strategy is properly designed. As noted earlier, early and transparent formulation of an overall strategy can build public support, counter the resistance of vested interest groups, and improve policy effectiveness. Rapid establishment of a supporting legal environment is essential. A clear statement of the restructuring goals makes it plain later on when the government should pare back its role and shut down restructuring institutions. Sunset provisions for government restructuring institutions can help limit their life spans.

The stages and process of SOE reform and restructuring in China suggests that the reform and restructuring was initially promoted and guided by the government, and gradually mediated partially by the market force and partially directed by government, and finally some of the restructuring is completely driven and led by the market. The study, undertaken by Jefferson and Rawski (2002), contrasts state-directed and market–mediated restructuring of enterprise ownership rights in transition economies. Market-mediated restructurings aimed at commercial objectives, and government-directed motivated by a mix of economic and political objectives.

Government-directed Restructuring

Governments, including provincial and local as well as central agencies, stand out as the chief actors in China's emerging property rights market. Direct official intervention arises from two distinct motives: limiting instability arising from layoffs and other manifestations of enterprise failure; and building large and powerful firms and enterprise groups that can complete successfully in global markets.

Early experimentation with mergers and acquisitions focused on small firms. More recently, large enterprises have entered the market for ownership rights. Capital Steel, First Auto Works (FAW), and Konka, a Shenzhen-based television manufacturer, are among the large firms that have employed multiple mergers to expand the breadth and scale of their operations.

Initially, government was the prime mover in most mergers. Non-commercial objectives predominated, as officials sought to escape the burden of supporting loss-making enterprises by merging them with stronger firms. These policies persist. Enterprises that hope to be listed on the stock exchanges must merge with or purchase a loss-making enterprise before they are listed. One author says that buyouts in China "basically represent low-payoff government activity" (Wei Feng 1999).

But in recent years, enterprises initiate acquisitions purely for business reasons: to acquire land-use rights, expand the scale of production, rationalize product lines, penetrate new markets, or ensure access to key inputs. Commercially motivated mergers include tie-ups among strong firms, such as the 1997 merger of four powerful petrochemicals firms in the Shanghai-Jiangsu region (Wang Shouan 1998) China's banks have begun to promote mergers as a means of strengthening client firms and reducing their own inventory of bad loans. The China Construction Bank has helped to arrange 39 mergers among firms in the cement sector, "slashing the non-performing loans ratio of cement makers from 80 percent in 1996 to 34 percent" in 2000 (Wang 2000).

During the 1980s, most mergers involved enterprises in the same trade, locality, and ownership system. Although these limitations still exist (Wei 1999, p. 10), they have begun to erode. Mergers that link firms in different industries, regions, and ownership systems are no longer uncommon. The television producer Konka is one of many firms that now operates plants in several provinces. Conglomerates like Capital Steel span diverse industries. Asset transfers involving state and collective firms, or state and private enterprises predate the recent policy of "retaining large state firms and releasing small ones," which has vastly expanded the opportunities for transactions formerly viewed as unorthodox. Another novelty is the entry of foreign firms into China's nascent property rights market. By the end of 1996, 10 of China's 59 largest tire manufacturers, 12 of the 13 largest pharmaceutical firms, and 70 percent of the largest beer producers have come under the control of foreign firms.

We also see a notable increase in the financial complexity of asset transfers. Initially, standard practice involved the acquiring firm gaining control of a target enterprise in exchange for full or partial absorption of the target's workers, retirees, and financial obligations. These transfers remain common, although policy shifts have repeatedly relaxed the financial requirements imposed on firms acquiring weak merger partners (Wei Xiangyun 1998). More recently, firms have begun to use capital markets as vehicles for mobilizing funds to finance corporate acquisitions. The Shenzhen-based Baoan group mounted China's first corporate raid in 1993, launching a surprise share-buying campaign that enabled it to become the largest holder of shares in Shanghai-based Yanzhong Ltd. (Wang 1998, p. 150). Konka, the television producer, has repeatedly used share issues to finance corporate takeovers (Wang 1998, p. 160). Although firms require official approval to gain access to domestic or international markets for shares or corporate bonds, some firms have succeeded in gaining indirect capital-market access through the device of purchasing shell corporations.

The creation of asset management companies associated with the four big banks adds a new dimension of enterprise re-organization. The government has provided these new entries with war chests amounting to hundreds of billions of yuan and instructed them to undertake debt-equity swaps and other approaches to workouts for heavily indebted firms. These amounts, while not large in relation to the total of bad bank debt, are quite substantial relative total non-performing assets. For example, Huarong, the AMC responsible for acquiring non-performing assets from the Industrial and Commercial Bank of China has purchased over 400 billion yuan of the Bank's non-performing assets, including stakes in over 70,000 enterprises. During 2000, Huarong began disposing of these assets, initially through auctions, judged to be the easiest method, and subsequently through direct restructuring, including mergers and acquisitions. Huarong executives are also confident that China's WTO membership will further the interest of major multinationals and investment banks in the purchase of large numbers of enterprises (Wang 2000).

It is anticipated that specification of control rights over publicly-held assets will continue to improve with the development of new systems of state asset management, the accelerated divestiture of assets under the 1998 policy of "retaining large public enterprises and releasing small firms," and the ongoing reorganization of rural enterprises.

Market-mediated Restructuring

Market-mediated restructuring also seems poised to expand, partly because of the accumulated impact of reforms-especially the on-going privatization of small firms, partly as a result f liberation measures linked to China's WTO accession, but particular because massive debt-equity swaps have quickly established China's four bank asset management firms as major players in the commercial segment of china's market for industrial property rights.

Despite strenuous efforts to implement the policy of separating government from business, firms and property remain enmeshed in a dense web of public ownership, official control, and bureaucratic regulation. Enterprise managers do hold substantial power and authority. In the areas of merger and acquisition or asset disposition, however, their capacity for independent action remains limited, even when legal provisions or national policies specifically ban official interference.[4]

Managers and workers of weak firms often resist proposed mergers. In some instances, labour unions or workers' associations wield effective veto power over enterprise restructuring. Managers may seek to obstruct proposed mergers in order to protect their own positions (Wang Kexia 1999). In such instances, the ambiguity of property rights may prevent a weak firm's owners from overriding insider opposition to change. As a result, restructuring may require direct official intervention.

Bureaucratic efforts to manage the restructuring process also create many difficulties, as when governments seek to escape the burdens of debt and redundancy by pushing strong firms into unprofitable alliances with weak partners. The recent merger between Shanghai's Baosteel and several floundering regional steel-makers, which saddled Baosteel with an enormously increased workforce, appears to represent this sort of forced merger, which Chinese authors describe as "forced marriages" (*lalangpei*).

Even when government plays no direct role in attempts to restructure specific enterprises, official policy exerts strong influence over the environment within which asset transfers occur. Ambiguous policy reflecting disagreements within official circles as well as shifting responses to changing economic circumstances creates additional barriers to the expansion of China's market for enterprise assets. The policies of "separating government from enterprises" and "retaining large state enterprises and releasing small ones" encouraged governments at all levels to reorganize public-sector enterprises under corporate, shareholding, cooperative, or private ownership, which facilitated the extraction of productive assets from the state sector (and by extension, from collectives as well). As local administrations move to transfer large numbers of enterprises and their assets out of the state sector, central officials attempt to slow down the process of restructuring, calling on "local governments to stop haphazardly selling off small State-owned enterprises".

3.4. Developing an Effective Corporate Governance System

Establishment of effective corporate governance mechanisms has become a key priority of reforms to ensure that SOE function effectively in a market environment. Two major objectives have guided the reforms in this area. The first is to establish mechanisms to exercise the state's ownership interest in SOE that are separate from the government's regulatory functions. The second objective is to set up internal governance mechanisms to provide incentives and accountability for managers to act in the interest of their owners.

Governance reform has involved a series of institutional and organizational transformations including: termination of the managerial functions exercised by government bureaus; establishment of a multi-tiered state asset management system; and the introduction of boards of directors and other modern governance mechanisms into corporatized firms. The success of the reforms in improving enterprise governance has been uneven: governance has improved most for SOE in competitive sectors and much less, if at all, for those in protected industries. Overall, the corporate governance mechanisms have not functioned nearly as effectively as was expected. This outcome is due largely to the fact that external discipline has remained weak; the state shareholder and regulatory functions have not been sufficiently separated in practice; and institutional and regulatory weaknesses prevent effective enforcement of the rights and obligations entailed in modern corporate governance mechanisms.

Like other transition economies, China faces the major challenge of establishing effective corporate governance systems in its SOE to ensure that they are competitive and can adapt to the changing demands of the market. Establishing effective governance of the SOE has become a key priority of China's current reform programme to set up a "modern enterprise system." Authorities are developing modern governance systems to push SOE to restructure and reorient managerial incentives to engage in profit-oriented, value-augmenting activities, in line with the owner's interest. Strengthening corporate governance is seen as an urgent task as Chinese policy makers have come to realize the increasingly adverse impact of the weak governance and ensuing inefficiency of the SOE sector on macroeconomic performance and the health of the banking sector. The imperative has also become urgent in view of China's prospective accession to the WTO. To deal with the increased competition from WTO membership, China's enterprises need to improve their decision-making mechanisms to compete successfully in domestic and international markets. Adoption of corporate governance mechanisms in line with international practice is also essential to the ability of China's enterprises to attract foreign capital in increasingly competitive global capital markets.

Ensuring that SOE are effectively managed is the ultimate challenge of corporate governance reforms. The key question is how owners - the state - can provide managers with incentives to use the firms' assets efficiently and act in the owners' best interests. Establishing effective governance systems in the context of SOE, however, has proven to be a difficult task throughout the world. International experience suggests that SOE usually suffer from the imposition of non-commercial objectives by the state, which hampers the ability of the enterprise managers to respond efficiently to market forces. SOE also tend to lack incentives and sanctions needed for good management found in private firms. This is primarily because the ambiguity of property rights associated with state ownership creates a situation where there is usually no clearly accountable representative of the state to monitor the performance of managers (Estrin 1998; Pannier 1996). In transition economies, SOE reform is usually made all the more difficult by the lack of external disciplinary mechanisms to support internal governance practices, such as efficient financial markets, competitive product and factor markets, and developed legal and accounting frameworks and enforcement mechanisms (Lin 2000).

The governments in OECD countries as well as in other transition economies have used a range of measures to improve the governance of their SOE, with varying degrees of success. These measures include: corporatization and restructuring; bankruptcy and other exit measures; and privatization (Iskkander 1996). The approach taken in most other transition countries has been to transform SOE into non-state companies through massive privatization. The different approach being taken by China is to force the SOE that will remain under state control to act more like private commercial firms through corporatization and the creation of governance structures to provide the incentives and disciplines that operate in private firms. Under this approach, the government is withdrawing from the management of enterprises while exercising its functions as owner and shareholder through separate entities created for those purposes.

3.4.1. Reform Measures to Improve Corporate Governance of SOE

Since the launching of the economic reforms, the Chinese government has attempted to improve the governance of SOE by introducing market-oriented incentives and disciplines. The earlier reforms introduced in the 1980s cantered on expanding managerial autonomy and incentives through contracts between managers and government supervisory agencies. In particular, the Contract Responsibility System provided greater material incentives for managers and workers by tying management autonomy, pay, and retained profits to the performance of SOE.[71] Control over SOE was decentralized, with all but 2,000-3,000 of the 118,000 SOE placed under the supervision of provincial and local governments instead of under the central government.

These earlier experiments led to considerable success in increasing productivity, but they also produced new, and initially unanticipated, problems. These problems arose because the reforms significantly increased the autonomy and control rights of insiders without adequately strengthening the oversight functions of the state/owners. On the one hand, reform measures centred on the use of incentive contracts were successful in improving the efficiency of SOE by motivating managers and workers to make and keep profits (Groves et al 1994). However, they also hindered longer-term enterprise performance by creating conditions for moral hazard, where managers and workers could make small gains at a large cost to the firm or to the economy by passing losses and liabilities to the state (Broadman and Xiao 1997). The rent-seeking behaviour of insiders led to such widely observed phenomena as speculative or uneconomic investments, asset stripping, diversion of enterprise funds to the insiders/managers, and excessive wage increases. At the same time, the decentralization of reforms led to the reduction in the ability of the central ministries to supervise the firms. The oversight ability of the government was substantially undermined because information necessary for monitoring could be distorted by insiders through a variety of means, such as false reporting of profits or soft loans to augment poor cash-flow. The decentralization of reforms also aggravated the problem of government intervention in day-to-day enterprise operations by creating additional layers of local agencies. The interference by numerous, uncoordinated government agencies (dubbed "mother-in-law") hindered the efficient decision-making of firms. The overall result of these conditions has often been characterized as "insider control under administrative intervention" (Zhang, 1998).

Since the early 1990s, policy makers and academics in China have increasingly adopted the view that poor SOE performance and weak governance is attributable to the "unclear property rights" and "lack of separation between government and enterprises". In the subsequent SOE reform programme, a major focus has been given to clarify property rights through corporatization; and to separate government ownership and regulatory functions by establishing the state as a shareholder with functions similar to those performed by private shareholders in other countries. A second major focus is to transform SOE into commercially oriented corporations with effective internal and external governance mechanisms. As discussed in Chapter IV, the shareholding of corporatized SOE is to be diversified through public listing in the stock exchanges, although the extent to which non-state shareholding in large SOE will be allowed is not yet clear. These reforms are intended to clarify property rights of SOE; delineate the roles of the state and the enterprises more clearly; and clarify and enforce the rights and responsibilities of the various actors participating in corporate governance.

Separating state shareholder function from regulatory functions

One of the major objectives of China's state shareholding reform is to separate the state's ownership/shareholder function from its regulatory functions by creating distinct agencies to manage state assets according to commercial principles. Accordingly, line ministries or departments that were responsible for SOE in the past are to be phased out so as to terminate their managerial functions in the enterprises. The rationale is that the government must delegate its ownership responsibilities if SOE are to have effective management and the internal governance mechanisms are to function effectively.

The reform of the state asset management system has created a multi-tiered network of institutions at the national, provincial, and municipal government levels to oversee and manage state assets. At the national level, the State Council acts as the ultimate owner of SOE assets on behalf of the Chinese people, with the National Administrative Bureau of State-Owned Property (NABSOP) acting as its administrative arm. At the provincial and municipal levels, State Asset Management Committees (SAMC) serve as similar upper-level bodies that are responsible for preserving and increasing the value of state assets.[73] Each SAMC oversees a number of state holding (sometimes called state asset management) companies (SHC) that manage the assets of SOE entrusted to their responsibility. In the case of large enterprise groups, their lead companies have been authorized to carry out the functions of SAMC and SHC for their constituent firms.

Under the division of labour established by these reforms, SHC are responsible for the management of the state assets and exercise of the state's ownership rights, but are accountable to the SAMC.

In most cases, the SHC have been constituted by transforming the traditional industry line government bureaus. The SHC have diverse ownership stakes in the companies under them, ranging from wholly owned to non-controlling interests in some joint-stock limited companies. Each individual SOE manages its own operations and is responsible for its own profits and losses. But they are subject to the ultimate control of the SHC, which have the legal claims to the returns on their shares in the SOE and bear limited responsibility for their enterprises' debts. SHC can also acquire shares of companies outside the group, including those affiliated with other SHC; in principle, this allows them to engage in restructuring through mergers and acquisitions with outside firms.

A parallel restructuring of the central government administration has complemented the new state asset management system. A major step in this regard was the reduction of central government ministries from 40 to 29 during the latter half of 1998. The primary rational of this restructuring was to eliminate most remaining industrial branch ministries in order to terminate their managerial functions in SOE. Economic ministries have been ordered to sever administrative ties with SOE and to maintain an arms-length relationship with their former affiliates. The central government has announced that this transformation will be carried out at the provincial and local levels during 2000.

Introducing internal governance mechanisms

Another major objective of the current reform is to strengthen internal incentives and monitoring mechanisms in shareholding firms by introducing modern corporate governance mechanisms into corporatized firms. The Chinese Company Law prescribes a system of corporate governance through three main bodies for joint stock limited companies (JSC): the shareholders' general meeting; the board of directors; and the board of supervisors. These internal governance mechanisms are intended to ensure effective corporate governance through the accountability of management to the board and shareholders; supervision and oversight of the board of directors and senior management by the supervisory board; and the accountability of the directors to the shareholders. The inspiration for the Company Law came largely from the civil law tradition of continental Europe, Germany in particular, and from Japan (Lin, 2000). As in Germany, the shareholders' meeting in China in principle has much broader power than in Anglo-Saxon countries. Like the German corporate model, China's corporate governance system requires employee representation on the supervisory board. Mandatory employee representation on the supervisory board reflects China's stakeholder orientation toward corporate governance, which is consistent with the traditional role of SOE in China and the continued emphasis on an economy with "socialist characteristics".

Efforts are also being made to introduce measures to strengthen managerial incentives for effective performance in corporatized SOE, although most of them are still on an experimental basis. Market-oriented behaviour of managers in China has been hampered by the lack of market-based selection of managers and weak managerial incentives. The market-based selection of managers has been constrained by the political and bureaucratic influence in the selection process as well as by the underdeveloped labour market for managers in China. Managers of state-owned or state-controlled companies also generally have weak material incentives due in part to the limited scope of performance-related compensation schemes for individual managers. To address these problems, the government has sought to encourage competition and other marked-based procedures in the selection of managers. The government has introduced, on an experimental basis, stock options as well as other remuneration packages more closely tied to company performance for managers and top executives of shareholding companies. It has also sought to improve training of SOE managers and to promote adoption of modern business techniques used in private firms. New training programmes for SOE managers have been set up in various localities; sometimes managers have been sent overseas to learn modern business techniques.

3.4.2. Weaknesses in the Corporate Governance Reforms in China

Overall, the reforms to improve corporate governance of large SOE in China have sought to establish the mechanisms that have been shown to be essential for efficient corporate governance of large firms in advanced market economies. In theory these reform measures were expected to improve the corporate governance practices of China's SOE. However, the general perception in China as well as available evidence seem to suggest that these reforms have not resulted in any appreciable improvement in the actual practices of corporate governance in either SOE or listed JSC. In fact, the those of other transition economies, have inherited a number of policy burdens as legacies of pre-reform policies. These include: state mandates to operate in capital-intensive industries; distorted output prices; pension burdens and other social welfare costs; and the inability to reduce redundant workers for the sake of social stability (Lin, 2000). In theory, the state should be responsible only for the SOE losses that arise from the policy burdens, not for those arising from the SOE's own operational inefficiencies. However, in practice, it is very difficult for the state to distinguish between these two. As a result, the managers can always ascribe their losses to the state's policies, not to their incompetence or opportunistic behaviour. Consequently, the state ends up taking responsibility for all the SOE's losses through direct subsidies or policy lending through banks. The poorly performing large SOE have been repeatedly bailed out by the state-owned banking system through policy lending and thus have not faced any real threat of bankruptcy or other exit measures. As a result, soft budget constraints, the absence of exit mechanisms and monopolistic rents have created especially large opportunities for rent-seeking by managers and government agencies. As long as these external disciplines remain weak, rent-seeking does not clearly affect the bottom line of firm.

Continued state dominance in ownership, control and governance

Second, the creation of mechanisms to separate government ownership and regulatory functions and to reduce government interference in SOE has not fundamentally changed the essential nature of the ownership and control by the state. Rather it has largely involved a shift of formal control rights from a single controlling (state) authority to a small number of alternative government institutions such as the SHC (Lin, 2000). The resulting control structure does not represent a clear improvement in the governance of SOE, in that the fundamental problem of multiple principles with insufficient incentives or ability to act as true owners in SOE governance has not been resolved; moreover, the multiple state institutions which now control the Chinese corporations are ones that suffer from weak corporate governance themselves.

Anecdotal evidence suggests that the newly established SHC, which in principle should operate as commercial entities, continue to be more bureaucratically, rather than commercially, oriented. They tend to be heavily influenced by their upper-level agencies, state asset management committees (SAMC), which continue to function like government administrative departments. The predominant method of creating holding process of corporatization since the early 1990s has been correlated with a significant deterioration in the performance of China's corporate sector (Lin, 2000). There is anecdotal evidence at the firm level that corporatization and public listing have tended to be viewed mainly as an inexpensive way to raise capital in the equity markets, involving at best limited obligations to improve corporate governance in the interests of shareholders (Steinfeld 1998).

The reasons underlying the continued weak corporate governance practices in China in spite of the reform measures are complex. But three main factors have been especially important.

Weak external discipline

First, the reform measures so far have put a major emphasis on delegating control rights and autonomy to managers and local governments, but have failed to impose strict external discipline or constraints on the main players involved in the corporate governance of large SOE. International experience in SOE reform suggests that the success of corporate governance reforms, regardless of the particular approach being taken, is only ensured when effective external disciplinary mechanisms are available to reinforce the internal corporate governance mechanisms (Iskander, 1996). Even without changing ownership, SOE can be forced to significantly improve their performance when strict financial discipline is imposed, as shown by New Zealand's experience. In China also the effectiveness of corporate governance has been shown to vary greatly across sectors according to their degree of product market competition and exposure to financial discipline. In particular, growing competition from non-state enterprises has been most instrumental in inducing market-oriented behaviours and improving profitability of the SOE located in the competitive sectors (Naughton, 1994; Jefferson and Rawski 1994). Evidence suggests that managers and the boards of these firms tend to be most responsive to external market forces and most effective in meeting their demands (Richet and Huchet 1999). In contrast, the economic behaviour of the large SOE or state-shareholding firms operating in the protected sectors - which largely comprise the "strategic" core - has been most resistant to the changes brought by various reform measures.

Large SOE in the core sectors have continued to enjoy state support in various forms, which partly results from the policy burdens imposed on them. China's SOE, as structures along industry lines further contributes to their bureaucratic orientation and tends to mix regulatory and commercial objectives. In particular, the SHC have been used to implement government-led restructuring of enterprises and workforce reductions in the industrial sectors for which they were previously responsible.

Even if these problems could be overcome, the international experience in many OECD as well as non-OECD countries has shown that the intended benefits of the public sector holding companies tend to be outweighed by their drawbacks. A range of additional difficulties have been associated with public sector holding companies in these countries. As in China, such holding companies tend to impose an additional layer of bureaucracy when the upper-tier institution is not effectively separated from the regulatory function of the state. Non-economic objectives frequently govern the functioning of state-owned holding companies, to the detriment of the commercial principles they are supposed to promote. Public sector holding companies formed along industry lines have often created obstacles to the development of competitive markets. In practice, public sector holding companies have proved effective only for: managing the largest natural monopolies and some strategic enterprises; or in specialized services such as corporate restructuring, dealing with financial crisis and managing bailouts, and preparation for subsequent commercialization and/or privatization (Baumann 1998).

At the same time, despite the reform objective of separating the government from enterprise management, the political/bureaucratic intervention by the state in the internal management of the SOE has continued. In particular, government involvement in the selection of senior management in large SOE is most problematic. The selection of managers continues to be heavily influenced by political and bureaucratic considerations, with various government authorities and their personnel departments influencing the appointment of senior managers (Steinfeld, 1998; Zhang, 1998). In the corporatized firms, the general manager tends to be pre-selected by the dominant or controlling shareholder, despite the statutory requirement that they should be appointed by the board of directors.

Ineffectual role of internal governance mechanisms

Third, the internal governance mechanisms introduced under the Company Law, such as the two-tier board structure, are potentially powerful mechanisms conducive to good corporate governance within the firm. However, in practice, the board structure does not appear to function as effectively as initially expected because it lacks several necessary checks and balances. First, the supervisory board in China tends to have very little power and independence to carry out its intended oversight functions. In the German model, the supervisory board appoints the board of directors, whereas under China's Company Law, they are appointed by the shareholders' meeting. Hence in China, the board of directors is directly accountable to the shareholders' meeting, rather than to the supervisory board as is the case in Germany. In addition, the supervisory boards in China are largely chosen by and subject to the controlling shareholder and do not effectively represent minority shareholders or other stakeholders. In fact, the members of the supervisory board have often come from retired company officials (Lin, 2000).

The effective control of corporatized firms tends to be concentrated in the hands of the general manager acting on behalf of a single majority or controlling shareholder (the state). Despite the statutory requirements, there is in practice little effective accountability of senior management to directors that are genuinely independent. The roles of the chairman of the board and the general manager are often combined; and the board is dominated by executive directors who have managerial responsibilities. The appointment of the general manager and other members of the board are largely dominated by the controlling shareholder. As a result, the board of directors is neither independent from management nor accountable to minority shareholders. This limits its ability to provide effective, independent monitoring of management in the interests of all the share and stake-holders.

The lack of independence of the supervisory board as well as the board of directors from insiders, and hence their ineffectual roles in China's corporate governance, suggest that there is a large room for improvement by clarifying and reinforcing the functions and responsibilities of the boards and other statutory arrangements in the Company Law. Both international experience and the corporate governance literature suggest that the role of the boards can be substantially strengthened by appointing a sufficient number of independent, outside directors. For example, the Cadbury Codes of the UK recommend at least three non-executive directors in the board. The OECD Principles also recommend that boards assign a sufficient number of non-executive members capable of exercising independent judgment to tasks where there is a potential for conflict of interest.[23] Effective oversight by boards also requires improved transparency and timely disclosure of financial information of the companies.

In developing and transition economies like China, the market and legal institutions and processes, which support good corporate governance practices in developed market economies, are relatively absent. China has made much progress in developing the legal and regulatory framework that supports its transition to the market economy. Critical legislation enacted recently includes: Company Law (1993), Central and Commercial Banking Laws (1995) and the Securities Law (1998) .The government has also been paying more attention to strengthening the regulations concerning accounting and disclosure standards. Nonetheless, the institutional and regulatory mechanisms that are necessary for ensuring good corporate governance practices are still relatively underdeveloped, which prevents effective enforcement of the rights and obligations entailed in modern corporate governance mechanisms. Thus, the challenge is not only to design and develop the legal and regulatory framework but also to ensure that the laws and regulations have the intended impact on the day-to-day decisions of economic actors. Establishing "rule of law" – rather than "rule by law" or "rule of man" – is another critical challenge facing China's enterprise reforms.

3.5. Mitigating the Social Impact of Restructuring: Social Security Reform

3.5.1. Social Impact of Enterprise Restructuring

The main concern in implementing enterprise privatization and restructuring is the social impact in terms of social service provision, unemployment, and social security. These concerns have been limiting the speed, scope, and quality of enterprise reform. Three key social dimensions need to be addressed in enterprise restructuring: (a) Enterprise social burdens would be reduced, and social service provision enhanced, through assistance to the transfer of social assets from state industrial enterprises to non-state operators or municipalities. (b) Unemployment would be addressed through strengthened retraining of labour for service sectors, and for the creation of micro and

[23] OECD Corporate Governance Principles 1999

small enterprises. (c) The funding of social security liabilities by enterprises would be facilitated by better using the value of enterprise excess assets.

Employment is typically a serious issue in restructuring SOEs. Inefficiency of SOEs is partly blamed for lifelong employment policy and lack of well-functioning labour market under a central-planned economy. Therefore, one of major purposes of restructuring is to eliminate redundant workforce and improve productivity and efficiency. For example, 435 large and medium-sized money-loss enterprises were closed down in 1998, and 32,000 small mines, 70 small oil refineries and 5,600 small petroleum plants were shutdown by the end of 1999. Some 4.1 million workers had been laid off in SOEs along with 2 million or so from non-state enterprises by the end of 2002. The re-employment rate for laid off in SOEs slid from 42% in 1999 to 36% in 2000, and 30% in 2001. The registered jobless in cities reached 7.1 million, or 4% of overall labour force by the end of 2002 (Xie 2003)

Redundancies and lay-offs arising out restructuring process have eroded the state workers contract of the iron rice-bowl. This has resulted in growing and sometimes violent labour unrest. The last decade has seen widespread redundancies in urban China. Appleton *et al* (2002) estimate in their survey of 13 cities in 1999/2000 that 11 % of urban workers had been retrenched since 1992. Appleton *et al* also claim that the redundancies have no doubt contributed to an improvement in the efficiency of state enterprises. However, there have been costs, at least in the short term, and there have been borne unevenly. Some of the redundancy criteria are consistent with efficiency objectives, but others look to be discriminatory. Redundant workers generally suffer a long and uncertain period of unemployment and bear a heavy loss of income; and possession of certain characteristics-not all of them related to efficiency- appears to impede reemployment. The subsequent outcome of the labour retrenchment has been labour unrest across the country.

Labour unrest in China since 1997 has shown that workers are not given advance notice of job losses or eased through a transitional period before actually being thrown out of work, the mood of acceptance which seems still to prevail among many employees of large SOEs can quickly shift to one of angry protest. The lack of communication with employees over the fate of loss making SOEs and the taking of crucial decision behind closed doors seem to be key factors causing these protests to escalate rapidly from the sending of delegations to officials to street demonstration s and sit-ins.

In addition to meeting the needs of China's ageing population, social security reforms are necessary to reduce financial burdens on enterprises and to provide a social safety net to deal with the human consequences of economic reform and industrial restructuring. Labour redeployment centres are the key instrument being used in the near term to support workers laid off from SOE and to assist them in finding new jobs. However, their scope has been limited by the scarcity of government revenues needed for their support; and their success in finding jobs for workers has been mixed.

Key priorities over the longer term are to extend unemployment insurance to improve labour market performance; to improve the distribution of medical care costs among workers, government, and enterprises; and to reform pension programmes. Current reforms are confined mainly to urban areas but extension of some programmes to rural areas is planned to begin in the next five - year plan. Over the longer term, the reforms will ultimately involve substantial further burdens on public finances and are likely to require changes in tax policies.

The traditional social welfare system prevailing in China since the early 1950s has guaranteed SOE workers a full range of social benefits including: lifetime employment; pensions; and health care. Many SOE have provided social services, such as education and housing, which in other countries are provided by local governments or the workers themselves. During the pre-reform period, these benefits were partly borne by employees in the form of low nominal wages *(i.e.* below their marginal product) while the rest were paid for by fiscal appropriations from the government.

Under the enterprise management reforms instituted at the beginning of the 1980s, SOE became responsible for these social welfare programmes but their scope remained largely as before. Direct contributions by employees to the programmes were minimal. The programmes continued to be administered by each individual enterprise, subject to government mandated standards, rather than incorporated into provincial or nation-wide schemes. Non-state enterprises, including township and village enterprises, were not required to provide comparable benefits and there has been no formal social welfare or safety net programme for the rural population. Benefits provided by SOE typically are not portable; nor has there been any unemployment insurance until very recently.

This antiquated social welfare system has become an increasing impediment to modernization of China's enterprise sectors in several ways. The system imposes benefit expenses on SOE that are relatively high on average and unevenly distributed (Table 3-11). Total outlays by SOE for social benefits (excluding the new unemployment insurance programme) have averaged around 30 per cent of their payrolls, but are 50 per cent or higher in the most heavily burdened cases.[107] These burdens have increased over time as the ratio of retired to active employees has risen with the ageing of the population.

Table 3- 11 Average social benefit expenses of SOE

Proportion of total payroll (per cent)	
Medical care	5.5
Pensions	20.0[1]
Worker's compensation	0.5
Housing	5.0
Unemployment insurance	3.0
Total	34.0

1. the statutory responsibility of enterprises. In practice, the proportion is often higher.

Source: Figures are based on estimates given in interviews with Chinese officials. The data are approximate averages and vary significantly among enterprises.

Apart from the direct effects on SOE, the system has also led to some broader problems. As indicated in Section 3.4, limits on social safety net facilities have not infrequently blocked efforts to reduce excess SOE workers and impeded M&A and other restructuring as well as bankruptcy. The lack of unemployment insurance and portability in benefits limit labour mobility. As in other countries, the provision of medical benefits at no cost to beneficiaries encourages their over-use and inefficiency in their provision.

Reforms of social benefit programmes have been actively underway in China since the early 1990s. The reforms have focused on unemployment insurance, health, and pension systems and are directed nearly entirely at urban workers and residents. A major reform to reduce SOE burdens for worker housing was scheduled to begin in 1998 but was postponed and no new date has been set.[108] Current policies are focused on urban areas but creation of a nation-wide social benefit system that would include rural areas is a longer-term goal.

3.5.2. Reforms to Deal with Lay-offs and Redundant Workers

The official rate of urban registered unemployment in China has been increasing since 1992 and reached 4.3 per cent during 2002-2003. However, this figure is acknowledged to seriously understate the true level of urban unemployment since lay-offs ("xiagang") workers resulting from SOE downsizing typically are not registered as unemployed. Estimates suggest that including these lay-offs would raise China's urban unemployment to more than ten per cent, and quite possibly as high as fifteen per cent.

The number of unemployed workers is expected to swell further in the year 2000 as Chinese companies shed staff to increase efficiency in preparation for the stiffer competition that WTO membership is expected to bring. Eleven million new workers will enter the urban work force in 2000. At least 4 to 5 million additional workers are likely to be laid off from SOE, urban collectives, military industries, and the civil service. Prospects for finding jobs for these workers are not good. Given their financial difficulties, urban collectives and SOE - even those without surplus labour – are unlikely to have much capacity to increase their employment. Increases in productivity have reduced the demand for the number of workers needed in many professions.[111] At recent trends, only about 6 million new urban jobs are likely to be created - less than half the total needed.

Mechanisms to provide lay-offs with basic living expenses for a transition period and to assist in finding new jobs are thus vital if SOE restructuring is to proceed. The existing strategy for accomplishing these objectives relies heavily on the "reemployment centres" (REC) discussed below. However, these centres are essentially a transitional arrangement. Under current plans, the centres have been phased out by the end of 2002 and replaced by the unemployment insurance arrangements that are now in the process of being developed.

Re-employment centres

REC were established to facilitate the large-scale exit of surplus workers from SOE and to better allocate the burden for their support among enterprises and local governments.[112] Before their emergence, local governments were solely responsible for providing living support to displaced workers and for assisting them in finding new jobs. This assistance was provided through re-employment agencies jointly managed by local government labour and finance bureaus and by trade unions. Funding for these re-employment agencies came mainly from local budgets, unemployment insurance funds, and social donations. However since funding was quite limited, permitted lay-offs were few and the cost of most surplus workers continued to be borne by the enterprises themselves.

The first REC was established by Shanghai Textile Holding Company (the former Shanghai Textile Bureau) as a pilot project in July 1996. The arrangements were subsequently expanded to other cities and regions and their use throughout the nation was mandated in the summer of 1998. REC typically are created and administered by local governments. Their functions are threefold: provision of a basic living allowance, re-training, and assistance in locating new jobs. Workers are allowed to stay with the REC for a maximum of three years; those who fail to find new jobs within this period are transferred into the unemployment insurance network. Access to REC has so far been limited to workers laid-off from SOE (workers transferred to subsidiaries or auxiliary units of SOE are not eligible). Financing for the centres is supposed to be shared on an equal basis by the SOE, local governments, and local social insurance funds.

According to figures compiled by the Ministry of Labour and Social Security, 11.9 million workers were in reemployment centres for at least part of 1999. In Hubei province alone, 7,492 RECs had been set up and were supporting about 350,000 former SOE workers (80 per cent of them from industrial SOE); a further 300,000 newly lay-offs are expected to enter the centres in 2000.

The overall record of the REC has been somewhat mixed. Nearly half of laid off workers have come from enterprises or localities that have insufficient financial resources to fully support the centres. In the worst cases, lay-offs have received virtually none of the basic income support to which they are theoretically entitled. Profitable SOE have often borne considerably more than one-third of the expenses of REC. Local governments have often required these firms to finance all or most of the expenses of their workers in the REC.[115] Abuses have also occurred, with many workers reported to have taken unreported jobs while remaining on the centres' rolls.

On the key criterion, the location of new jobs, the performance has been better. More than half of the workers that have entered the centres are reported to have since found new jobs; official figures indicate that 4.5 million laid-off SOE workers found new positions in 1999 alone. In Shanghai, 92 per cent of 1 million laid-off have found new jobs in the past three years. Not surprisingly, progress has been less in slower growing regions: in Hubei province only 30 per cent of the workers in REC managed to find new jobs in 1998. However, the overall record seems good considering the rising unemployment rate and falling employment growth in urban areas over the past several years. The majority of the new jobs have been in service industries, and a large fraction has come from private firms. The role of the REC in these placements, as well as their effectiveness in retraining workers, has been questioned, since a large proportion, and perhaps most, of the jobs seem to have been found through friends or relatives. Nevertheless, the ability of local labour markets to absorb a relatively high fraction of the lay-offs has been critical to allowing SOE to continue to shed substantial amounts of their surplus workers.

Unemployment insurance

The unemployment insurance system was first established in China in the mid-1980s to ensure that urban unemployed workers had a basic living allowance. The system is now being expanded and reformed with the ultimate goals of providing interim support for all unemployed workers, relaxing constraints on enterprises' ability to adjust their labour forces, and improving labour market integration and labour mobility. While now confined to urban areas, extension of unemployment insurance coverage to rural areas is envisaged to begin in the next five-year plan beginning in 2001.

Nearly half of China's urban workers were registered with the system by the end of September 1999. Registered workers who become unemployed are eligible to receive basic living subsidies for up to two years; in the first year, the subsidy level equals that given to workers in the REC, but the subsidy is reduced by 50 per cent in the second year.

Under the new unemployment insurance regulation that came into effect on 1 November 1999, coverage has been extended to all urban workers including those in private enterprises, self-employed workers and contract rural workers. Required contributions are 3 per cent of wage payments, of which two-thirds is paid by the enterprise and the remainder is paid by the worker through a payroll deduction.

Unemployed workers who have received subsidies for two years, and workers who have been in REC for three years, are transferred into the more general welfare programme providing a minimum allowance for living expenses that is available in principle to all urban residents. In 1999 this programme, which is funded from local government budgets, was functional in 668 cities and 1,689 counties. The amount of the allowance varies by region, according to their cost-of-living.

3.5.3. Health and Pension System Reforms

Reform of health and pension programmes is essential not only to reduce current burdens on enterprises but also to meet the needs of China's rapidly ageing society. As with unemployment insurance, health and pension programmes are now largely confined to urban workers and residents.

Health care

For most of the reform period, SOE have been fully responsible for the medical costs of their employees. Initially, SOE were compensated for these expenses by government appropriations. However under the management reforms instituted in the mid-1980s, SOE became responsible for their own expenses and profitability. Government reimbursement for medical care was withdrawn in principle, although in practice the government continued to provide funding for SOE unable to meet the expenses on their own. Medical care responsibilities have led to steadily rising costs in relation to payrolls in a manner quite familiar in many OECD countries. As in the OECD, the costs have been aggravated by the limited incentives to economize on health care services that are largely provided to workers without explicit charge to themselves. The heavy burden of health care costs has become one of the constraining factors on the economic performance of SOE. As with pensions, health care burdens vary considerably among SOE, and even more between SOE and non-state enterprises, as well as across regions. Disparities in health care coverage as well as the lack of portability of benefits have discouraged labour mobility.

Pilot programmes to unify the management of medical funds under local governments were carried out in certain cities in the beginning of 1990s. The unification diminished to a certain extent disparities in health care burdens among SOE. But it did not drastically reduce the overall burden on SOE, nor did it address the gap in burdens between SOE and other enterprises.

In November 1993, a new health reform plan was instituted, with the objective of reducing financial burdens on SOE and increasing the responsibility of workers for the cost of their health care. The plan creates a two-tier system of benefits comprising individual medical accounts and a community wide pool ("unified" account). Workers contribute 2 per cent of their salaries through payroll deductions to the individual accounts. Enterprises contribute a further 6 per cent of salaries, 30 per cent of which goes into the individual accounts and the remainder into the unified account. Medical expenses are paid in the first instance from the individual medical accounts. Once the account is exhausted, a worker is normally responsible for paying any additional medical expenses.[118]

Implementation of the reforms is still at an early stage: by 1999, 24 of China's 41 provinces had established reformed medical insurance programmes. Partly because of the early stage of the reforms but also because of rapidly rising medical care costs, there has as yet been little if any reduction in SOE burdens for medical care. The reforms represent a very initial and limited step toward improving incentives to economize on health care provision. Although workers now contribute a modest amount out of their own payroll, choices among plans, co-payments for specific treatments, and other provisions that have been needed to improve incentives elsewhere do not yet exist.

Pension reforms

China's demographics alone pose a formidable problem for its pension programmes. The proportion of the population above the age of sixty is expected to increase by nearly fifty per cent over the next 10 years, to reach 10 per cent by 2010.[24] Public pension plans, which presently cover SOE workers together with government employees and the military, are virtually entirely pay-as-you-go. Pension burdens vary markedly: the average ratio of retirees to current workers is nearly 2 to 1 for SOE established during the 1950s versus half that ratio for enterprises established in the 1970s or later. The divergence in pension obligations is the major source of the discrepancies in overall SOE social welfare expenses. A large and growing number of SOE are financially unable to meet their pension obligations.

[24] OECD(1998), "OECD Labor/Management Programme: Policy Implications of Ageing Societies", OECD Working Papers No.21; "Maintaining Prosperity in an Ageing Society".

Since 1993, authorities have been instituting major pension reforms in order to achieve three basic objectives. The first is to provide more sustainable funding mechanisms to meet current needs and especially to deal with the rapid projected rise in outlays in the future. The second objective is to reduce overall SOE pension burdens as well as the divergences in these burdens among enterprises. The third objective is to extend the coverage of pension programmes to the non-state sector, in part to level the competitive playing field among various types of enterprises and to improve labour mobility.

Policies to address these problems began in 1993 with the establishment of individual pension accounts. The system that has since emerged is based on three "pillars". The first is a basic defined-benefit plan financed by contributions proportional to a worker's salary. The second is an individual pension account financed by (compulsory) contributions from workers; while the third is a voluntary supplementary plan financed by individual firms or insurance policies purchased by workers. In 1997, the three elements were integrated and the separate funds were unified and placed under the management of agencies of the provincial and local governments. Contributions were standardized at 13 per cent of salary for the basic benefit (currently being paid by enterprises); with a further employee contribution of 11 per cent of salary paid into the individual pension accounts. In principle, total contributions paid by the enterprise itself are supposed to be limited to 20 per cent of workers' salaries.

By the end of June 1999, the new pension network had been expanded to cover 110 million retirees, 26 million more than in 1998. Beginning in 1999, the coverage of pensions is being gradually extended to include the non-state sector.

As yet, the pension reforms have not appreciably reduced financial burdens on SOE as a whole. This is partly because the social pooling in the new arrangements applies mainly to new workers and so does not address the pensions due to current retirees. Burdens have been shifted somewhat, but mainly from loss-making and low profit SOE that are unable to meet their obligations to more profitable SOE, which in some cases are required to pay more than the theoretical maximum of 20 per cent of salaries.

Beyond the near term, the success of the pension reforms is limited by the poor financial conditions of the two main pillars, SOE and local governments. With the deterioration of the financial situation of SOE, the collection rate of the social security fund has been decreasing. Moreover, local governments, particularly those in the less developed central and western areas, are often too financially strained to fully meet their obligations. The fall in payments from these sources has been only partly made up by additional contributions coming from non-state enterprises as coverage is expanded. Largely as a result, the deficit of the pension pools has been rising rapidly, and reached an estimated total of 100 billion yuan in 1999.

The gap between pension obligations and the present and prospective resources available to meet them is growing. Expanded coverage, while it has alleviated the near-term squeeze on the funds, increases pension obligations over the longer term. Financing of the unfunded pension obligations solely through existing mechanisms would likely increase burdens on enterprises to untenable levels.

Chapter 4 Theoretical Framework and Hypotheses

In the preceding chapter, I developed and described alternative models of enterprise restructuring and relationships between CSR, corporate governance and firm performance. Drawing on the models and theories from the literature, in this Chapter, the theoretical framework and the hypotheses will be developed. In Section 4.1, the theoretical framework will be proposed based on the stakeholder theory, and Section 4.2 describes the hypotheses with regard to relationships between corporate social performance (CSP) and financial performance (FP) during pre-and post-restsrcuturing.

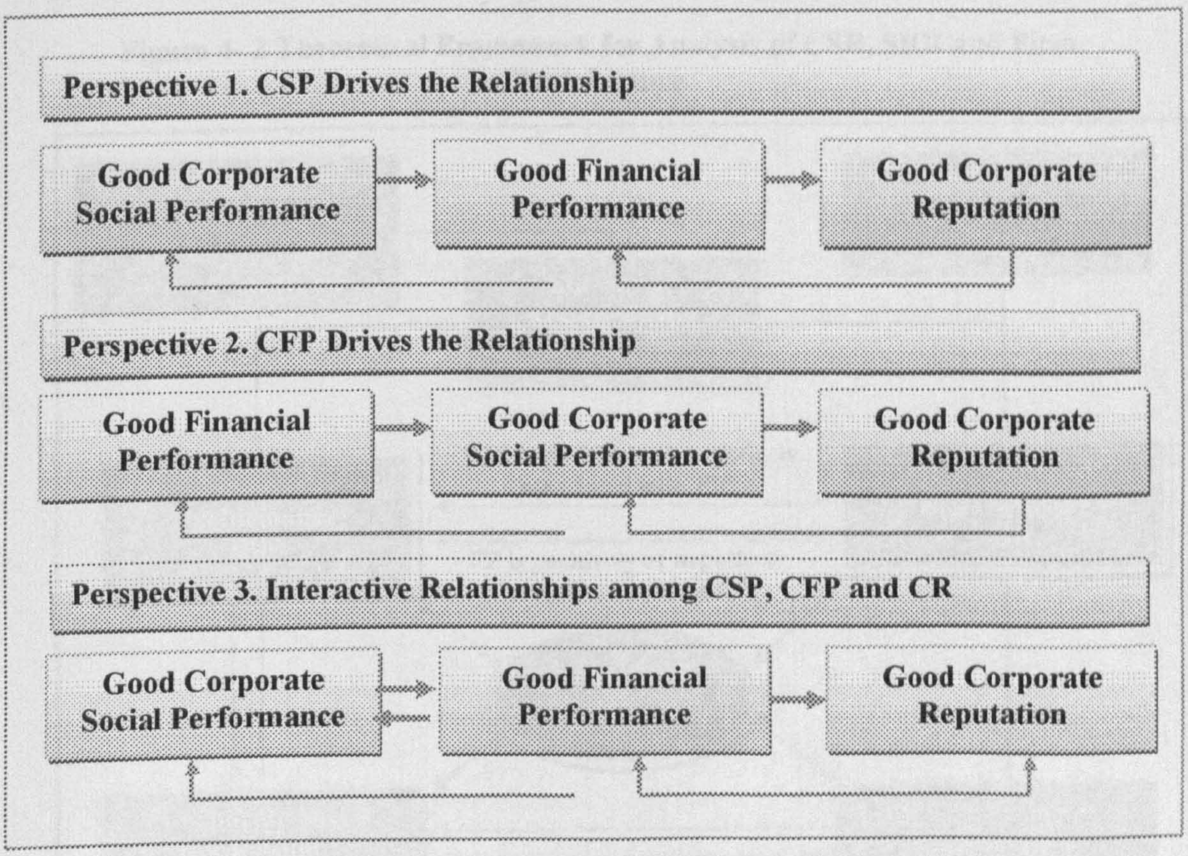
4.1. Theoretical Framework for Analysis

Over the past years, research into the relationship between CSP and FP has been based on several theoretical arguments; three main different views or perspectives have dominated these discussions and research (Carroll & Buchholtz 2003). The perspective one is built on the belief that socially responsible firms are more financially profitable. To those who advocate the concept of social performance, it is apparent why they would like to think that social performance is a driver of financial performance and, ultimately, corporation's reputation. If it could be demonstrated that socially responsible firms, in general, are more financially successful and have better reputations, this would significantly bolster the CSP view, even in the eyes of its critics. Over the past two decades, the Perspective one has been studied extensively. Unfortunately, the findings of most of the studies that have sought to demonstrate this relationship have been either flawed in their methodology or inconclusive. Numerous studies have been done well, but even these have failed to produce conclusive results. In spite of this, some studies have claimed to have successfully established this linkage.

Perspective two, which has not been studied as extensively, argues that a firm's financial performance is a driver of its social performance. This perspective is built somewhat on the notion that social responsibility is a "fair weather" concept; that is, when times are good and companies are enjoying financial success, we witness higher levels of social performance. In their study, Preston and O'Bannon found the strongest evidence that financial performance either precedes, or is contemporaneous with, social performance. This evidence supports the view that social-financial performance correlations are best explained by positive synergies or by "available funding."

Perspective three argues that there is an interactive relationship among social performance, financial performance, and corporate reputation. In this symbiotic view, the three major factors influence each other, and, because they are so interrelated, it is not easy to identify which factor is driving the process. Regardless of the perspective taken, each view advocates a significant role for CSP, and it is expected that researchers will continue to explore these perspectives for years to come.

Figure 4-1. Relationships among Corporate Social Performance (CSP), Corporate Financial Performance (CFP) and Corporate Reputation (CR)



Source: *揃usiness & Society: Ethics and Stakeholder Management,*" Carroll & Buchholtz 2003.

Figure 4.1 depicts the essentials of each of these views. A basic premise of all these perspectives is that there is only one "bottom line" - a corporate bottom line that addresses primarily the stockholders', or owners', investments in the firm. An alternative view is that the firm has "multiple bottom lines" that benefit from corporate social performance. This stakeholder-bottom-line perspective argues that the impacts or benefits of CSP cannot be fully measured or appreciated by considering only the impact of the firm's financial bottom line.

To truly operate with a stakeholder perspective, companies need to accept the multiple-bottom-line view. Thus, CSP cannot be fully comprehended unless we also consider that its impacts on stakeholders, such as consumers, employees, the community, and other stakeholder groups, are noted, measured, and considered. Research may never conclusively demonstrate a relationship between CSP and financial performance. If a stakeholder perspective is taken, however, it may be more straightforward to assess the impact of CSP on multiple stakeholders' bottom lines.

Figure 4- 2 Theoretical Framework for Analysis of CSR, SRR and Firm Performance

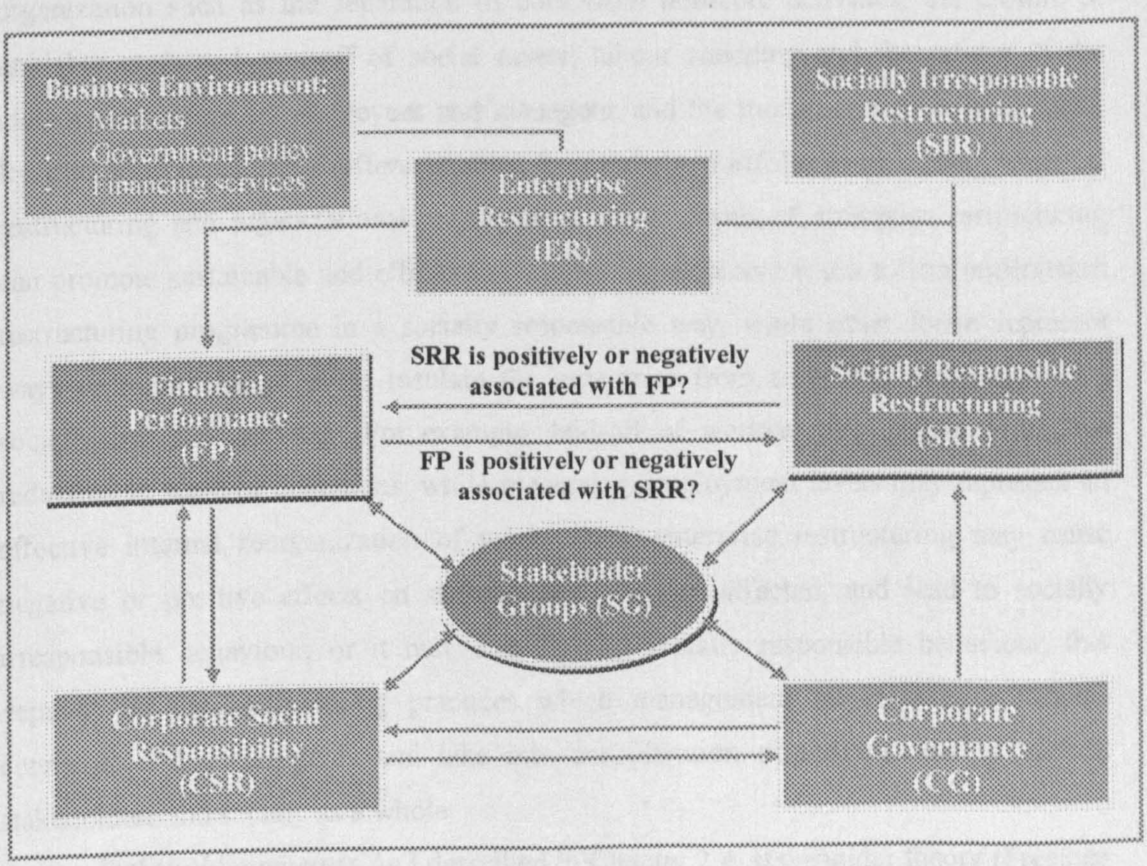


Figure 4-2 presents the theoretical framework built on the multiple stakeholders' bottom lines. The theorectical framework follows the previous views in literature in seeking to link firm performance and socially responsible performance to the four key factors such as enterprise restructuring, stakeholders, corporate governance, and corporate social responsibility. These four factors directly and indirectly interact with each other through stakeholder actions, and the joint forces of the factors influence the extent of the firm's performance. This framework is used to examine the relationship between socially responsible restructuring and firm's financial performance.

Enterprise restructuring: Enterprise restructuring involves some substantial change in the organization, activities and relationships in which the enterprise is involved with the stakeholders, such as employees, shareholders, suppliers, government, customers, environment, etc. As reviewed in Chapter 2, restructuring is defined as the changes that state-owned enterprise has to undergo in order to emerge as equivalent to a private sector firm (Aghion *et al* 1997). It typically entails changes in internal organization such as the separation of core from non-core activities, the closure of unviable units and spin-off of social assets; labour shedding and the reform of the incentive structure for employees and managers; and the modernization of equipment. Restructuring takes many different forms, for example, portfolio restructuring, financial restructuring and organizational restructuring. Some forms of enterprise restructuring can promote sustainable and efficient economic development when a firm understakes restructuring programme in a socially responsible way, while other forms represent ways to resist change or to insulate the enterprise from economic challenges in a socially irresponsible way. For example, laid-off of workers may reflect a reactive reduction in scale of operations, while preserving employment levels may represent an effective internal reorganization of work. Thus, enterprise restructuring may cause negative or positive effects on stakeholders who are affected, and lead to socially irresponsible behaviour; or it may also lead to socially responsible behaviour, this depends on the restructuring practices which management might take to balance economic and social goals and take into consideration of the interests of various stakeholders and society as a whole.

Stakeholder groups: As I described in Chapter 2.4, stakeholder theory (Freeman 1984, Blair 1995) is becoming dominant corporate governance model in recent years. This model claims that the firm should serve wider interests of stakeholders rather than shareholders only. It is a core concept in this framework. On the one hand, gaining a better understanding of the firm's performance and social responsibility, has been accounting for and managing the interests or "stakes" of key players inside and outside of the organization. Difference in and conflict among various stakeholders can have a dramatic effect on the ability of any organization to perform efficiently and in socially responsible way (Becker and Potter 2002). On the other, different stakeholders have different types and degrees of power such as voting power, economic power, and political power (Freeman 1984). Stockholders typically have an opportunity to vote on such major decisions as mergers, acquisitions, and other extraordinary issues. Through the exercise of informed, intelligent voting, they may influence firm policy so that their investment is protected and produces a healthy return. Customers, suppliers and retailers have a direct economic influence on the firm. Their power is economic in nature. Customer can choose to boycott products or an entire firm if they believe the goods to be too expensive, poorly made unsafe, or inappropriate for consumption. Suppliers can withhold supplies or refuse to fill orders if a firm fails to meet its contract responsibility. Government exercises political power through legislation, regulations or lawsuits. Other stakeholders also exercise political power, using their resources to pressure government to adopt new laws or regulations or to take legal action against a company.

It's argued that stakeholder action is part of the mechanism linking social performance with FP, based on the assumption that for socially responsible (irrisponsible) behaviour to influence financial performance, stakeholder groups must be cognizant of the firm's behaviour, be willing to take action to influence the firm, and have the capability to do so.

In this framework, the main stakeholders who can be affected by or influence the design, implementation, and outcomes of enterprise restructuring, include the shareholders, employees, government, customers, communities, business partners, and the general public.

Corporate social responsibility: CSR is defined as companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis. CSR can result in a wide range of stakeholder reactions including political action, purchase decisions and investment decisions. Corporate stakeholder theory (Cornell and Shapiro 1987) suggests that a firm must satisfy not only stockholders and bondholders, but those with implicit claims. The stakeholder theory contends that the value of a firm depend on the cost not only of explicit claims but also of implicit claims. If a firm does not act in a socially responsible manner, parties with implicit contracts concerning the social responsibility of the firm may attempt to transform those implicit agreements into explicit agreements that will be more costly to it. For example, if a firm fails to meet promises to government officials in regard to actions that affect the environment, government agencies may find it necessary to pass more stringent regulations, constituting explicit contracts, to force the firm to act in a socially responsible manner. Moreover, socially irresponsible actions may spill over to other implicit stakeholders, who may doubt whether the firm would honor their claims, thus, firm with an image of high corporate social responsibility may find that they have more low-cost implicit claims than other firms and thus have higher financial performance (Cornell and Shapiro 1987).

Corporate governance: Corporate governance is defined as the process by which organizations are directed, controlled and held accountable, and requires balancing the interests of various stakeholders and society as a whole with the economic goals of the organizations. It involves a set of relationships between a company's management, its board, its shareholders and its stakeholders. It deals with the rights and responsibilities of a company's management, its board, shareholders and other stakeholders. CSP can be analyzed and evaluated more effectively by using a framework based on the management of a corporation's relationships with its stakeholders than by using models and methodologies based on concepts concerning corporate social responsibilities and responsiveness (Clarkson 1995).

Good corporate governance should strive to protect different stakeholders of the firm against the need to give managers and controlling owner's excessive incentives and freedom to manoeuvre. The corporate governance literature increasingly recognizes that fairness of treatment, job satisfaction, high quality of work environment and particularly income and job security are important factors in generating investments in firm-specific capital by employees (Blair 1995; Kelly and Parkinson 1998; Slinger and Deakin 2000). Corporate governance is concerned with all of the dimensions of CSR identified above; it is the way that ethics is dealt with at the governance level.

4.2. Hypothesis Development

The statistical hypothesis testing was employed to estimate whether a relationship on the cases studied suggests there is a relationship among the population from which the sample was drawn. This research hypothesis will address a directional issue, whether a relationship is positive or negative.

4.2.1. Managers' Attitudes toward CSR and Socially Responsible Behaviours

I start with the assumptions that the managers, whose attitudes are more in favour of CSR, can engage in a more socially responsible restructuring than those are against CSR. Katz (1960) has suggested that attitudes provide people with a framework within which to interpret the world and integrate new experiences. Ajzen and Fishbein (1977) further suggested that by understanding an individual's attitudes toward something, one could predict that individual's "overall pattern of responses" to the object. They argued that a single behaviour is determined by the intention to perform the behaviour in question. A person's intention is in turn a function of his attitude towards performing the behaviour. Therefore, not only will managerial values frame the issues evaluation process but they are also likely to directly shape the issues management process as well.

Management's intentions as represented by their beliefs, attitudes, and desires, are primary motivators that influence organizational processes and ultimately are reflected in corporate programmes and policies. Wood's model (Wood 1991b) underscores individual or managerial intentions as the motivators of socially responsible behaviour, the management of stakeholder expectations as an integral part of the process, and an emphasis on programmes and policies as the primary outcomes of those processes.

Whereas managerial intentions are presumed to drive behaviour, it is the manager's attitudes toward CSR that predispose action. Attitudes have always been assumed to be extremely important elements in social cognition. Defined as a broad disposition to respond positively or negatively to a stimulus (Fiske and Taylor 1991), attitudes predispose actions that are consistently favourable or unfavourable toward some object (Ajzen and Fishbein 1977). An Assessment of a manager's attitudes toward to CSR, then, shall provide an indication of the manager's predisposition to respond in a particular way to CSR. Therefore, on the basis of the attitudes-behaviour theory, the hypothesis is developed to test the relationship between the manager's attitudes and his socially responsible behaviour.

Hypothesis 1: The managers orientated towards social responsibility pay more attention to social issues arising from restructuring than other managers.

4.2.2. Socially Responsible Restructuring and Firm's Performance

The aim of the present study is to extend the previous research into relationships between CSR and financial performance by using the special Chinese case. The hypotheses with regard to socially responsible restructuring (SRR) and financial performance will be formulated based on the theoretical framework and arguments.

Social Impact Hypothesis

In the literature on CSR, the stakeholder theory (Cornell and Shapiro,1987a) believes that favourable social performance, e.g. meeting the needs of various corporate stakeholders, will ultimately lead to favourable financial performance.), and failure to meet the expectations of various non-shareholder constituencies will generate market fears, which, in turn, will increase a company's risk premium and ultimately result in higher costs and/or lost profit opportunities. According to their analysis, serving the implicit claims of major stakeholders (e.g., employees, and customers) enhances a company's reputation in a way that has positive impact on its financial performance; conversely, disappointing these groups may have negative financial impact. This "social impact" version of the stakeholder theory implies a lead-lag relationship between social and financial performance; external reputation (favourable or unfavourable) develops first, then financial results (favourable or unfavourable) follow. However, previous statistical tests of this hypothesis have not produced supportive results (McGuire, Sundgren, and Schneeweis 1988; Preston, Sapienza, and Miller 1991), in this study, I attempt to investigate the relationship socially responsible performance and firm financial performance in the context of enterprise restructuring in China.

Hypothesis 2a: SRR is positively related to financial performance, higher (lower) socially responsible performance leads to higher (lower) financial performance.

Trade-off Hypothesis

The trade-off hypothesis asserts that social performance is the independent variable and that social accomplishments involve financial costs. This hypothesis reflects the classic Friedman position and is supported by the well-known early finding of Vance (1975) that corporations displaying strong social credentials experience declining stock prices relative to the market average. More recently, the trade-off hypothesis has been carefully articulated by Aupperle *et al* (1985). They point out that socially responsive activities (e.g., charity, environmental protection, community development, etc.) may siphon off capital and other resources from the firm, putting it at a relative disadvantage compared to firms that are less socially active. Hence, a firm's higher levels of social performance may lower its financial performance as compared to competitors and/or other norms.

Hypothesis 2b: SRR is negatively related to financial performance, higher (lower) socially responsible performance leads to lower (higher) financial performance.

Available Funds Hypothesis

Another possibility is that social and financial performance are indeed positively associated, but that the causal or lead-lag relationship is from financial to social performance. Although firms may wish to follow the normative rules of good corporate citizenship at all times, their actual behaviour may depend on the resources available. Hence, profitability in one time period may increase a firm's ability to fund discretionary projects, including social performance projects. In the previous lead-lag studies, McGuire *et al* (1988) found a stronger positive relationship when financial performance was viewed as the leading variable, and their results were partially supported by Preston *et al* (1991). Kraft and Jerald Hage (1990) found that the availability of slack resources (i.e., previous profits), the values and goals of managers, strongly influenced the level of community service undertaken by corporations. I explore these lead-lag relationships in my third hypothesis.

Hypothesis 2c: Financial performance is positively related to SRR, higher (lower) financial performance leads to higher (lower) socially responsible performance.

Managerial Opportunity Hypothesis

It is argued in the literature that corporate managers may pursue their own private objectives, to the detriment of both shareholder and other stakeholders (Williamson 1967; Weidenbaum and Vogt 1987). Recent surveys support the view that top managers consider their own interests of primary importance, or second only to those of customers, in corporate decision making (Posner and Schmidt 1992; Alkafaji 1989). The "managerial opportunism" hypothesis states that pursuit of private managerial goals, in the context of compensation schemes closely linked to short-term profit and stock price behaviour, might lead to a negative relationship between financial and social performance. The reason is that when financial performance is strong, managers may attempt to "cash in" by reducing social expenditures in order to take advantage of the opportunity to increase their own short-term private gains. Conversely, when financial performance weakens, managers may attempt to offset, and perhaps appear to justify, their disappointing results by engaging in conspicuous social programs.

Hypothesis 2d: Financial performance is negatively related to SRR, higher (lower) financial performance leads to lower (higher) socially responsible performance.

The hypothesis about relationship between the managers' attitudes towards CSR, and their behaviours in restructuring will be tested against the data collected by the structured management survey in 250 Chinese firms. The hypotheses about the relationship between socially responsible restructuring and firm performance will be examined against the data collected from 318 listed firms over seven years from 1997 to 2003.

Chapter 5 Data and Methodology

This Chapter presents the research methodology and data analysis for the study. In section 5.1, I will describe the methodology and research design including what reserch methods and why I use them in the study; Section 5.2 suggests the sampling strategy in the survey. Section 5.3 discusses the qualitative and quantitative data, and in Section 5.4, I will present the data analysis techniques to interprete the collected data.

5.1. Research Methodology

According to Margolis and Walsh (2002), 122 published studies between 1971 and 2001 empirically examined the relationship between CSR and financial performance (FP). Empirical studies of the relationship between CSR and FP comprise essentially two types. The first uses the event study methodology to assess the short-run financial impact (abnormal returns) when firms engage in either socially responsible or irresponsible acts. The second type of study examines the relationship between some measure of CSP and measures of long term financial performance, by using accounting or financial measures of profitability.

This study employs the second type of methodology by using a combination of survey, financial statements, and articles on companies in the popular press, company reports, and other online database to assess CSP. The financial data were collected to investigate the change in firm's financial performance in pre- and post-restructuring of 318 sampled listed firms over the 7 years (1997-2003).

5.1.1. Research Design

The research questions of this study address the phenomena of CSR, socially responsible restructuring and firm's performance and their relationships. Specifically, the study empirically examines the attitudes of the managers towards CSR, and whether their attitudes influence their behaviours in restructuring; investigates the relationship between socially responsible restructuring and firm's financial performance, and the case study of state-ownded defence industry. The three perspectives that the study examines are logically integrated. It is assumed that by understanding an individual's attitudes toward something, we can predict that individual's overall pattern of response to the object. An assessment of a manager's attitude toward CSR may provide an indication of the manager's predisposition to respond in a particular way to CSR. Thus, different attitudes toward CSR (in faviour of or against) might result in the different behaviours (socially responsible or socially irresponsible actions), and different behaviours might lead to various firm's performance (higher or lower). By analyzing the case study, we can have comprehensive and deep insight into the CSR issues, and have a fuller understanding of the process of socially responsible restructuring in China.

I employed two main models of data collection and strategies, i.e. the survey method and the case study.

Survey Method

In this study, the management survey was conducted in 250 sampled firms between 2003 and 2004. The objective is to investigate how the Chinese managers perceive CSR, and whether the socially responsible value-oriented managers undertake restructuring in a more socially responsible way.

This survey is a cross-sectional study and stem from a random sample based on the whole population. I am interested in accurate assessment of characteristics of a whole population and from the samples I can infer the characteristics of the defined population. The survey was conducted by the structured questionnaires which was developed in 2003. The questionnaires was designed by drawing information from sources of CSR literature; SOE reforms, industry and government studies and surveys of ownership restructuring. The questionnaires were pre-tested in some of the Chinese enterprises in late 2003 to determine whether the questions are realistic, and could be generalized across firms, and are understandable in the general context of the overall study. Resultant comments and suggestions have been incorporated into the final questionnaires. The questionnaire contains 56 multi-part questions, most of which the forced-choice questions with an open-end provision for suggested additional entries.

Case Study Method

The case study method provides an opportunity to make an in-depth investigation, but has a limitation on the number of companies to be studied due to time and cost constraints. Therefore, this research will be limited to few cases in order to conduct an in-depth investigation of the cases.

The case study was conducted to assess attitudes of managers toward CSR and how managers are restructuring their enterprises during the transition period. In selecting cases from the manufacturing sector, I focused on the following characteristics:

- Large enterprises: The industry should contain large enterprises, which have a significant effect on the Chinese economy in terms of employment, production and capital investment. This study includes firms, which employ a relatively large number of employees and companies which had a large amount of capital.

- Good cases: The enterprises under study should be suitable for an in-depth case study of the phenomenon under investigation.

- Comparability. The companies should present comparable accounting information, but should also be distinctive on other aspects.

Using the above criteria, China South Industries Group Corp. (CSIGC) was selected as the case study because of its unique feature in the restructuring. CSIGC is one of large State-owned enterprises in defence industry, it has been converted to civilization industries such as automobile and motorcycle manufacturing, optical and electronic industries. It started enterprise restructuring in 2001 with the focus on structural adjustment, debt-to-equity swap, mergers and acquisitions, bankruptcy. Over the past few years, over 12 companies were bankrupted and 20 companies was planned to close down or go bankrupt, and another 20 firms implement spin-off programmes, and more companies were encouraged to set up shareholding companies with multiple ownerships. It's inevitable that more employees and workers have to be downsized and laid off. For example, on the basis of the policy CSIGC made "determining staff size according to the scale of the enterprise", CSIGC laid off 27,000 redundant workers in 2001 (Yang 2002). However, CSIGC management has developed restructuring strategy by adopting the socially responsible approaches to assist lay-offs to find new jobs, 13,800 people found new jobs in 2001. Many of the companies in the group have been doing well in the socially responsible restructuring, but I selected only 3 companies as the case studies, and paid a visit and conducted interview with top managers in early 2004.

The case study was developed in two phrases. The first step focused on management survey on perceptions of managers toward CSR and socially responsible restructuring. The survey was designed with the structured questionnaires, and was conducted in 2003-2004. The in-depth interviews were held with 55 executives and managers from the group. The second stage was the field visits which were carried out from 16 February to 1 March 2004. The visits were organized in four cities respectively in Beijing, Henan, Jiangxi and Chongqing. In Beijing, where CSIGC headquarters is located, senior executives and managers were interviewed about the recent reforms in defence industries; the major issues and problems confronted by defence industry restructuring, and the restructuring strategies and policies.

The first firm I visited was COSTAR Group Corp. in Henan Province. It is one of large optical and electronic industries under control of CSIGC. COSTAR was successfully acquired the bankrupted defence industry in Henan province, and adopted active labour re-deployment programme and successfully deploy the redundant and unemployed workers. Then, I visited the Yangtze Chemical Company (YCC) in Jiujiang city of Jiangxi Province. It is one of the defence SOEs under CSIGC engaged in the research and production of non-metal synthetic materials. YCC is one of the most successful cases in enterprise restructuring in CSIGC. The case is characterized by adoption of employee share ownership programme (ESOP) after spin-off of social assets and ownership restructuring. All the displaced workers were redeployed, and contributed to local economic development. During the visit to YCC, I met the senior managers, and interviewed managers from the new spun-off firm. This case study will be analyzed in detail late in this chapter. In Chongqing, which is one of the defence industry bases, I interviewed the managers from Chang'an Automobile Co., Ltd, Jianshe Motorcycle Industrial Co., Ltd, and Jialing Industrial Co., Ltd. After the field visits, The firsthand information and data were collected to give me the in-depth insight of recent enterprise restructuring in defence industry in recent years.

5.1.2. Data Collection

In this study, I have two datasets, the primary data were collected through the structured survey and interviews. The secondary data were mainly financial data collected from companies under study and policy documents.

Qualitative Data

The qualitative data of the managers' attitudes toward CSR, stakeholder orienation, and involvement of CSR activities were collected by the The questionnaire The questionnaires are divided into five main parts:

1). Enterprise profiles and background: including industrial sector, start-up date, location, supervisory authority, company size, ownership.

2). Perceptions of managers about CSR: covering 11 questions concerning the attitudes toward relationship between CSR and Financial performance; CSR and public image and reputation, CSR and public relation positioning, CSR and legislation, CSR and labour relations, and CSR and constituencies (government officials, bank and investor), and interpretation of socially responsible behaviour in restructuring.

3). Enterprise Restructuring: including the indicators for determining socially responsible performance in restructuring including the extent of involvements of employees, local community and government; effective communication, alternatives of restructuring, downsizing, social service package for laid-off and redundant workers, redeployment of redundant workers, labour disputes, spin-off of social functions, etc..

4). Business environment: covering the indicators influencing firm performance such as competition, business environment, financial constraints, and soft budget constraints.

5). Corporate governance: covering boards of directors, supervisory boards, and selection of top managers.

Quantitative Data

Accounting data collected include financial data such as income statements, balance sheets and other supporting financial documents and the questionnaires data collected to assesss the response of managers with respect to restructuring activities.

The financial data were collected for the period of 1997 to 2003 for 318 listed firms when the state-owned enterprises underwent a national-wide and aggressive transformation from SOEs to shareholding companies. The financial data indicate, in terms of financial measures, the response of managers to the economic reforms, whether they are adjusting to the new market environment and whether they are improving firm performance after restructuring.

In order to assess the change in firm's performance of pre-and post-restructuring, I have collected financial variables relating to company operations (sales, costs and operating profits), company investments (total assets), and company finances (total debet, ownership equity). These variables are used to answer the firm's performance change. The objective of collecting these financial variables is not only to assess the firm's performance, but to identify the factors which affect the performance and behaviours of managers in restrucutring activity.

I referred to three additional sources to ensure the quality of my data,. First I am able to access a wide range of online database of Chinese business and economic development such as Global M&A Research Centre,[25] China Security Regulatory Commission (CSRC)[26], and China Entrepreneurs' Survey System (CESS).[27] Second, I also made broad use of official publications related to enterprise reform and restructuring, i.e. China M&A Yearbook (2001, 2002, 2003 and 2004); China M&A Review (2003); China Listed Company Reports (2003). Third, whenever possible I interviewed senior managers and executives from Chinese state-owned and private companies.

5.2. Sampling Strategy

My sample was based on the list which I compiled of about 1256 firms in China which had undergone substantially restructurings during 1997-2003. The three main sources for the list are the database of managers, who have attended the courses of International Training Centre of the ILO (Turin, Italy), the data of restructurings of listed firms between 2000 and 2001,[28] and database of CSRC and SINA Financing and

[25] The updated information on M&A in China is available at the website: *http://www.mergers-china.com/*

[26] All information about China listed firms is available at the website designated by CSRC: *http://www.cninfo.com.cn/default.htm*

[27] CESS was established in 1993. It covers most of the datasets of enterprise surveys since 1993 (see detail at the website: *http://www.cess.gov.cn/cess/jianjie.asp*)

[28] It's available at Review of China M&A, 2003 and 2004.

Stock.[29]

The first sample was taken from the list of firms for the purpose of management survey. I selected a random sample of 250 large and medium-sized firms to whom I sent a detailed questionnaires by mail. The questionnaires were addressed to the senior managers and executives with recommendation to direct it to managers who were involved in restructuring activity.

The second sample was selected from the firms listed in domestic stock market (both Shanghai and Shenzhen Stock Exchanges) since the 1990s. The rationale for choosing the listed firms for the analysis is that (1) most of my sampled firms were transformed from SOEs or partially privatized through ownership restructuring and shareholding reform; (2) after listing, the listed/partially privatized firms have undergone asset restructuring in order to configure and optimize industrial structure and improve profitability and efficiency; (3) the financial and accounting data are easily available and reliable, it is standardized against the international accounting standard, and comparable; (4) the listed firms are the typical modern corporations, and they are responsible for not only creating values for shareholders, but for protecting other stakeholders such as employees, investors, customers, communities and environment. Therefore, the data collected from the listed firms can provide me with multidimensional measurements of corporate social performance, although the selective bias for financial data of listed firms need to be taken into consideration, because falsification and fabrication of financial data has taken place in listed firms very often.

For the purpose of sample of the listed firms, for the original compiled list, I draw a systematic sample by using a sampling fraction of 1/3 and select every third firm after a random start. By using sampling fraction of 1/3, I got the total 415 firms. However, the firm should be in line with the selection criteria: (a) The firm shall be restructured in 1997-2003; (b) At least three years of pre- and post-restructuring financial data; (c) At least three years of pre-and post-employment data. In the end, only 318 firms were kept in my sample against the criteria. The required 1995-2003 consumer price index (CPI) values for China come from the World Development

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29 The full list of restructured list firms is available at the website: *http://finance.sina.com.cn/stock/company/calling/0201060000.shtml (2004)*

Indicators Database (World Bank 2005).

5.2.1. Sample of Management Survey

Table 5-1 describes the results of collected data. Out of 250 cases targeted I ended up collecting data for 83 firms representing 33.2 percent of total sample. Of those, 18 are failed to provide complete information, and 149 didn't respond or denied to provide information I requested.

Table 5- 1 Observations in the Sample of Management Survey

	No. of firms	*% of sample*
Firms in my final sample	83	33.2
Firms that supplied incomplete information	18	7.2
Firms that didn't respond or denied to give information	149	59.6
All sampled firms	250	100

Table 5-2 reveals the summary of my final sample. The distribution of sample by region indicates that the data covers the whole country, but mainly most of sample is from North China (41%), South China (30%) and West China (23%), where most of large and medium-sized state-owned enterprises are located and have undergone the significant restructuring and privatization since the late 1990s. In the sample, over 84 percent of the sample is state-owned enterprises, and more than 96 percent of large and medium-sized. The result of data also shows that my sample covers seven industries, however, mainly focus on manufacturing industry such as metal and machinery (47%), and automobile manufacturing (15.7%).

Table 5- 2 Summary of Data of Management Survey

	No. of firms	*% of sample*
Location of the firm		
North China	34	41.0
South China	25	30.1
East China	5	6.0
West China	19	22.9
Industrial Sector		
Petrol and chemical	11	13.3
Motor	13	15.7
Electronic and optical	10	12.0

Metal and machinery	39	47.0
Construction	5	6.0
Electricity and power	3	3.6
Transportation and storage	2	2.4
Firm Size		
Large	59	71.1
Medium	21	25.3
Small	3	3.6
Ownership		
State-owned	70	84.3
Collective-owned	3	3.6
Shareholding	8	9.6
Private	2	2.4

Table 5-3 shows the profile of managers responding to the structured survey. Although Over 14 respondents couldn't provide their personal information, we still can see that most of our respondents are between 45 and 65 years old, most of them are men. More than 60 percent received high education, in peculiar, on management and polytechnic areas.

Table 5- 3 Profile of Managers Responding to the Survey

	No. of respondents	***% of Sample***
Age		
35-45	17	20.5
46-55	28	33.7
56-65	22	26.5
Missing	16	19.3
Sex		
Male	68	81.9
Female	1	1.2
Missing	14	16.9
Education		
Above university	24	28.9
University	37	44.6
Below university	8	9.6
Missing	14	16.9
Professional		
Economic	7	8.4
Management	22	26.5
Polytechnic	40	48.2
Missing	14	16.9

5.2.2. Sample of Listed Firms

Table 5-4 presents the final sample of 318 firms comprising of 17 industries and

32 provinces throughout China (see Table 5-5).

Distribution of sample by industry

Table 5-4 shows that the sample covers most of sectors, but it focuses on pharmaceutical (21.1%), automobile (16.4%), electricity (12.9%), and chemical (11.6%) industries. Most of companies in these industries have been listed on stock market through transformation of ownership and spin-off, for example, in 2003, there were totally 1250 listed firms in China, of these, 58% (722 firms) were related to manufacturing industries including pharmaceutical and biological, machinery and mechanic, petrol and chemical, automobile, electricity, gas and etc (Wang and Shen 2004). Since the late 1990s, these sectors have been very active in restructuring driven by both market competition and government restructuring strategy after listing in the stock market. In 2003, firms in manufacturing industries underwent significant M&A transactions, particularly in the areas of machinery, equipment, IT, electricity, gas and energy, and petrol and chemical (Wang and Zhang 2003).

Table 5- 4 Characteristics of Sampled Firms by Industry

Industry	*No. of firms*	*% of sample*
Pharmaceutical and biological	67	21.1
Motor	52	16.4
Electricity, gas and energy	41	12.9
Petrol and chemical	37	11.6
IT	22	6.9
Real estate	17	5.3
Electrical	16	5.0
Metal and machinery	14	4.4
Transport and storage	10	3.1
Post and telecommunications	9	2.8
Food, beverage and tobacco	8	2.5
Retail and wholesale	7	2.2
Textile and leather	7	2.2
Agriculture, forestry, animal husbandry and fishery	5	1.6
Construction	2	0.6
Publishing and media	2	0.6
Tourism and Hotel	2	0.6
Total	**318**	**100**

Distribution of sample by location

It's assumed that the firms headquartered in economically advanced regions usually experienced more restructuring events and more likely are listed in stock markets because of the dynamic economic development. Most of the sampled firms are located in the well developed areas. It shows in Table 5-5 that 107 sampled firms are located in East China (33.6%), and 75 in Central China (23.6%). It's interesting to notice that most of the sampled firms are from North East (Liaoning, Jilin, Heilongjiang), and South West (Chongqing, Sichuan). Northeast China is the country's old industrial base. However, dragged by the legacy of a planned economy, the region's contribution of industrial output value to the national total decreased from a remarkable 17% in 1978 to 9% in 2002. In view of this, revitalizing the old industrial base of Northeast China was put on top of the central government's agenda at the 16th Communist Party Congress in November 2002. By speeding up the restructuring of SOEs and attracting investment by foreign companies, China aims to rebuild the Northeast region into a competitive industrial base for the essential equipments and raw materials.

Sichuan and Chongqing are the most populous and industrialized regions in Southwest China, in 1983, they became the first areas to experiment with comprehensive economic restructuring. Along with the cities in Northeast, Sichuan and Chongqing are among the oldest industrialized regions and have more SOE problems. Many SOEs in Sichuan and Chongqing were built in remote mountain areas and statutory towns where an enterprise functioned as their social roles. A number of the enterprises were experiencing management dilemmas. The losses incurred in the large and medium-sized enterprises were 20 percent higher than the nation's average in 1998. In recent years, the proliferation of national defence research establishments in Sichuan and Chongqing have concentrated on non-military, i.e. commercial applications. It provides a technology-rich industrial environment, in particular on the three principal industrial sectors: automotive, pharmaceutical and metallurgical. Sichuan and Chongqing have been forced to address critical restructuring problems with urgency. Great progress has been achieved in this area and, in 2000, large and medium-sized industries in Sichuan and Chongqing began to turn a profit for the first time in many years.

Table 5- 5 Characteristics of Sampled Firms by Geographic indicator*

	No. of firms	*% of sample*		*No. of firms*	*% of sample*
	Region			***Region***	
East China	107	33.6	North East	40	12.6
Central China	75	23.6	North China	39	12.3
South West	42	13.2	North West	15	4.7
	City			***City***	
Beijing	17	5.3	Henan	5	1.6
Tianjin	6	1.9	Hubei	21	6.6
Hebei	6	1.9	Hunan	9	2.8
Shanxi	5	1.6	Guangdong	32	10.1
Inner Mongolia	5	1.6	Guangxi	6	1.9
Liaoning	19	6.0	Hainan	2	0.6
Jilin	9	2.8	Chongqing	11	3.5
Heilongjiang	12	3.8	Sichuan	22	6.9
Subtotal	40	12.6	Guizhou	2	0.6
Shanghai	40	12.6	Yunnan	3	0.9
Jiangsu	18	5.7	Tibet	4	1.3
Zhejiang	12	3.8	Shaanxi	4	1.3
Anhui	8	2.5	Gansu	5	1.6
Fujian	8	2.5	Qinghai	2	0.6
Jiangxi	1	0.3	Ningxia	1	0.3
Shandong	20	6.3	Xinjiang	3	0.9

Note: East China includes Shanghai, Jiangsu, Zhejiang, Anhui, Fujian, Jiangxi, Shandong; Central China includes Henan, Hubei, Hunan, Guangdong, Guangxi, Hainan; South West includes Chongqing, Sichuan, Guizhou, Yunnan, Tibet; North East includes Liaoning, Jilin, Heilongjiang; North West includes Shaanxi, Gansu, Qinghai, Ningxia, Xinjiang.
** The Geographical classification is in line with the China Statistical Yearbook 2003*

Distribution of sample by ownership

Table 5-6 represents the ownership before ownership transformation. My sample focuses on SOEs accounting for 85.8 percent, and the rest are collective enterprises (7.2%), private firms (4.4%), and joint venture (2.5%). What's more, all the firms in my sample underwent the ownership restructuring into shareholding system, but of which, 62.9% were done during the period of 1992-1995, and 26.7% in 1996-1999 (Table 5-7).

Table 5- 6 Original Ownership before Ownership Restructuring

	No. of firms	*% of sample*
SOE	273	85.8
Collective Enterprise	23	7.2
Private firm	14	4.4
Joint venture	8	2.5
Total	318	100.0

Table 5- 7 Ownership Restructuring by Dates

	No. of firms	*Percent of sample*
1985-1991	33	10.4
1992-1995	200	62.9
1996-1999	85	26.7
Total	318	100.0

Table 5-8 shows that more half of the firms in my sample were listed in the stock markets during the period of 1996-1999, and about 35% listed in 1990-1995. In other words, more firms had undertaken shareholding restructuring programmes in the late 1990s than in the early 1990s. The reason is that since 1990s, when SOEs were transformed into shareholding companies, the company stock listing was constantly expanding in size and the relevant rules and regulations were being refined constantly. From 1992 to 2001, the number of listed companies rose from 53 to 1160; the fund raised annually rose to 125.234 billion yuan from the initial 9.409 billion yuan, with the fund raised in 2000 rising as high as 2103.08 yuan; the ratio of the market stock price and the GDP rose from 3.93 percent to 45.37 percent. During that period, regulations and laws including the Opinions on Standardizing the Joint Stock Limited Companies, the Provisional Regulations on the Administration of Issuing and Trading of Stocks, the Securities Law of the People's Republic of China and the Criterion Governing the Listing Companies were successfully issued, constituting important guaranty for the standardized operation of the listed companies (China Business 2003).

Table 5- 8 Listing on Stock Markets by Dates

	No. of firms	*% of sample*
1990-1995	110	34.6
1996-1999	172	54.1
2000-2002	36	11.3
Total	318	100.0

Sample of assets restructuring

As I introduced previously, the main strategy for reviving listed firms' fortunes in the late 1990s was asset restructuring. This is a broad category denoting a reorganization of a firm's assets and liabilities in order to restore it to long-term financial health. In the sample, 53.1% of firms underwent the asset restructuring in 2000, and 46.9% in 1999 (see Table 5-9). The methods which were used in the restructuring include transfer of shareholding (38.1%), merger & acquisitions (34.6%), asset disposal (20.8%) and others (6.6%) (see Table 5-10). Therefore, M&A and share transfer agreement for the transfer of either state shares or legal person shares are the principal corporate restructuring vehicles. The alternative methods for corporate restructuring such as asset sales, assets for equity swaps also become more common.

Table 5- 9 Assets Restructuring by Dates

	No. of firms	*% of sample*
1999	149	46.9
2000	169	53.1
Total	318	100.0

Table 5- 10 Assets Restructuring by Methods

	No. of firms	*% of sample*
Shareholding Transfer	121	38.1
M&A	110	34.6
Asset Disposal	66	20.8
Asset Sale	16	5.0
Shareholding	5	1.6
Total	318	100.0

The samples constitute a small sample share of the firms in China; therefore, the data might be not representative. However, the selection bias is, however, minimized whenever possible. Enterprises were sorted alphabetically by name and random draws will be taken. The sample does include firms located in different regions in China.

The sample is unique in several dimensions. First, it is based on a consistent survey methodology to study socially responsible restructuring and firm performance in China's corporations. Second, it contains enterprises from different sectors and regions within a country thus allowing me to control for the importance of sectoral and regional factors in analysis of financial performance. Finally, it covers a dynamic period in the transformation process when redistribution of ownership was rapidly taking place. This in turn enables me to document the evolution of ownership structure.

5.3. Data Analysis

As stated in the preceding chapter, the data for this study has two parts, part one is about the survey of management attitudes toward CSR; and part two about the data of examination of relationship between socially responsible restructuring and financial performance in the listed firms. The characteristics of the both datasets are described as follows.

5.3.1. Qualitative Data Analysis

As discussed in the preceding chapter, the managers were interviewed with structured questionnaires. They were asked to respond to the statements. The statements address the attitudes for and against CSR, and the perceptions of managers toward socially responsible restructuring. The questions consist of a mixture of 'favourable and unfavourable' statements to which managers were asked to respond for expressing their extent of agreement and disagreement. A favourable attitudes toward CSR gets a high score, thus for 'positive statements' 'strongly agree' gets a high score, while for 'negative statements', 'strongly disagree' gets high score. Then, each score of each item is added up to obtain scale score. The scale score was used to assess the extent of managers' attitudes to which managers were in favour of or against CSR, and the extent of managers' behaviours to which they acted in a more socially responsible manner in restructuring.

The questions in the structured questionnaires are given on a five-point interval scale which ranges from (5) strongly agree to (1) strongly disagree. The questions on determinants of socially responsible restructuring are also determined on a five-point scale ranging from strongly agree to strongly disagree, and then, socially responsible performance in restructuring were ranked on a five-scale ranging from "major concern" (1) and "concern"(2) on the low side, through a neutral ranking (3) , to "strength"(4) and "major strength" (5) on the positive side.

Analysis of Managers' Attitudes toward CSR

Two different perceptions of managers toward CSR shall be determined by assessing the statements of CSR in the survey.

Attitudes in favour of CSR: there are seven statements: (1) engagement of a firm in socially responsible actions doesn't conflict with pursuit of profit; (2) a business that wishes to capture a favourable public image will have to show that it is socially responsible (3) If business is more socially responsible, it will avoid additional regulations of the economic system by government, and reduce restricts in firm's operation; (4) involvement by business in improving its local community's quality of life will also improve long run profitability; (5) firm perceived as being socially responsible can encounter relatively low level of labour problems; (6) socially responsible activities can improve a firm's standing with bankers and access source of capital; (7) socially responsible activities can improve a firm's standing with investors and reduce financial risk.

Attitudes against CSR: four statements: (1) business already has too much social power and should not engage in social activities that might give it more; (2) there is no difference between involvement of a firm in socially responsible activities and public relations positioning; (3) high social responsibility can put a firm at an economic disadvantage compared to less socially responsible one; (4) business will participate in social responsibility more actively in prosperous economic times than in recession.

Measurement of CSP in Restructuring

Corporate social performance (CSP), which is defined in Chapter 1, refers to a business organization's configuration of principles of social responsibility, process of social responsiveness , and policies, programmes , and observable outcomes as they related to the firm's societal relationships (Wood 1991a). Building on this definition, Wood and Jone (1995) propose that stakeholder theory is the key to understanding the structure and dimensions of the firm's societal relationships. They redefine the policies, programmes, and outcomes as "internal stakeholder effects, external stakeholder effects and external institutional effects", and argue that stakeholders set norms for corporate behaviour, experience the effects of corporate behaviour, and evaluate corporate behaviour. I adopt Wood and Jone's modification of Wood's definition of CSP. To operationalize this definition, I use outcome measures on the relationships that firms have with stakeholders.

I used two sets of indicators produced from two sources to measure CSP in the restructuring activity. The first set of indicators was produced from the management survey, and the second for listed firms was identified from database of Shanghai and Shenzhen Stock Exchanges, and other sources as I explained preceding section.

CSP indicators in the Survey

The indicators of socially responsible performance are developed as a tool for measuring extent to which a company lives up to socially responsibility in restructuring. The indicators provide a broad measurement of a company's social responsibility covering the following elements:

- The extent to which employee/workers' representatives and local community is kept involved by the management in the process of restructuring;
- The extent to which communications are opened to those who are influenced by the restructuring;
- The extent to which the innovative approaches to restructuring such as upgrading of existing production line, opening of new plant, successful development of major production line, increasingly investment in R&D are developed;
- The extent to which workforce is downsized (less than 20%); and
- The extent to which social support programme such as re-deployment of lay-offs is provided to assist workers in finding new jobs.

CSP Indicators for the Listed Firms

CSP is determined on the basis of the sources provided by the ratings on quality of information disclosure, ethical and moral issues and workforce reduction (downsizing).

1) Disclosure of information to shareholders: The basic framework for information disclosure in the Chinese security markets has been established by CSRC and other relevant authorities. According to the rules of CSRC, information disclosure is an ongoing responsibility of listed companies. A listed firm should truthfully, accurately, completely, and timely disclose information required by laws and regulations. The information disclosed to shareholders should cover listed firm's ongoing information, corporate governance in accordance with laws, regulations, and other relevant rules, and controlling shareholder's interests. The ratings of information disclosure for each firm were produced by Shenzhen and Shanghai Stock Exchanges cover the year 2000, 2001, 2002, and 2003. The quality of disclosure was assessed on the statutory disclosure requirements by CSRC regulations and Code of corporate governance: whether the information disclosed to shareholders and other stakeholders is timely, accurate, complete and legal, and also extent of impact of information disclosure on stock market and investors. A four point scale was produced: - 1 = below the average; 0 = average; 1= above average; and 2 = well above average. The information disclosure was regarded as one of the CSP indicators in the restructuring activity.

2) Ethic and moral issues: The extent to which a firm abides by the company laws and other related regulations and rules was accessed on the lawsuit cases brought up to courts by the company stakeholders, and punishments made by CSRC. The data is available in the Shanghai and Shenzhen Stock Exchanges. The cases of lawsuits were involved in the weak protection of stakeholder rights such a disputes of shareholding transfer, labour disputes in restructuring, frequent insider trading, self dealings, collusions in market manipulations; falsification and fabrication of financial data. All these cases were concerned about the ethic and moral problems in management and corporate governance.

3) Workforce reduction: workforce reductions (downsizing) is regarded as another important indicator for measuring CSP. The extent to which downsizing influences stakeholders was accessed on the scale of workforce reduction. The five point scale of downsizing was produced on the basis of comparison of concurrent-restructuring year and post-restructuring year. If the company has reduced its workforce by over 15% after restructuring year, the firm has "major concern"; by less than 15% but more than 10%, "concern", by less than 10% , but more than 5%, "neutral"; by less than 5% "strength", and firms with no job cuts or created new jobs have "major strength".

The above three dimensions of CSP indicators are taken to reflect the interests of some important stakeholders- shareholders, investors, creditors and employees. Each item was ranked on a five-point scale — which meant putting numerals to KLD's ratings, ranging from "major concern" (1) and "concern" (2) on the low side, through a neutral ranking (3), to "strength" (4) and "major strength" (5) on the positive side. The scores for each dimension were then added up to provide each firm with overall scores for scale score. A high score indicates the firm has higher CSP in restructuring, while a low score indicated the firm has lower CSP.

5.3.2. Financial Data Analysis

The financial data were collected to investigate the change in firm's performance in pre- and post-restrtucturing in listed firms under study, and to test the hypotheses about the relationship between socially responsible performance and financial performance in restructuring.

The four indicators of financial performance are used: profitability which I measure by sales growth, return on sales (ROS), return on assets (ROA), and return on equity (ROE); efficiency which I measure by the sales efficiency and net income efficiency ratios (real sales and net income per employee respectively). ROE reflects profitability of the firm by measuring the investors' return. Return on equity is measured by the mean net income / owners' equity. Return on assets reflects the asset utilization of the firm in the capital intensive industry. Return on sales was also selected as a profitability measure because of its sensitivity as an overall indicator of profitability. ROE offers a useful signal of financial success since it might indicate whether the company is growing profits without pouring new equity capital into the business. A steadily increasing ROE is a hint that management is giving shareholders more for their money, which is represented by shareholders' equity. ROE indicates know how well management is employing the investors' capital invested in the company. ROA gauges how efficiently a company can squeeze profit from its assets, regardless of size. A high ROA is a telltale sign of solid financial and operating performance.

The sales efficiency (the sales-per-employee ratio) is used to compare companies that are similar. Companies with high sales-per-employee figures are generally considered as more efficient than those with lower figures. A higher sales-per-employee ratio indicates that the company can operate on low overhead costs, and therefore do more with fewer employees, which often translates into healthy profits.

It has been argued that all governments launching restructuring/privatization programmes have specific, and generally very optimistic, expectations about what these programmes will yield. Governments expect that restructured/privatized firms will increase total sales, become significantly more efficient and profitable, increase their capital spending, and become financially healthier; yet all governments fear these benefits will come at the economically (and politically) painful cost caused by reduced employment in the restructured/privatized firms.

Since 1992, China has been experimenting with Western style corporate forms as a way to improve the profitability and efficiency of SOEs. More SOEs have been transformed into different modern corporations through restructuring of SOEs into limited liability firms and joint stock firms under the Chinese Law (1993).

In the context of SOE restructuring and privatization, the Chinese government objectives include: improving firm's profitability and efficiency through market discipline and competition; getting rid of SOEs bad debt and reducing government subsidies to inefficient SOEs; optimizing industrial structure through efficient allocation of resources; and defining and transferring property rights. This study, beyond investigating the relationships between socially responsible restructuring and financial performance, also examines whether after restructuring, governments or management are able to achieve the objectives. Drawing on the standard methodology of Megginson and Nash (1994); D'Souza and Megginson (1999); Wei et al (2003); Narjess and Jean-Claude (1998), the hypotheses were developed and tested in the study. The hypotheses are concerned with (1) a firm's profitability increases; (2) a firm's operating efficiency increases, (3) a firm's employment decrease, and (4) a firm's leverage decreases after restructuring. Table 5-11 details the economic characteristics I will examine for changes resulting from restructuring, based on the avowed objectives of the governments launching restructuring programmes. I also present and define the preferred and alternative empirical proxies I employ in my analyses. The index symbols *pre and post* in the predicted relationship column stand for before and after, respectively.

Table 5- 11 Summary of the Testable Hypotheses

Characteristics	*Proxies*	*Predicted Relationship*
Profitability	Return on sales (ROS)=Net income/Sales	$ROS_{post} > ROS_{pre}$
	Return on assets (ROA) = Net income / total assets	$ROA_{post} > ROA_{pre}$
	Return on equity (ROE) = Net income / total equity	$ROE_{post} > ROE_{pre}$
Operating Efficiency	Sales efficiency (SALEFF) = Sales / total employment	$SALEFF_{post} > SALEFF_{pre}$
	Net income efficiency (NIEFF) = Net income / total employment	$NIEFF_{post} > NIEFF_{pre}$
Employment	Total Employment (EMPL) = total number of employment	$EMPL_{post} < EMPL_{pre}$
Leverage	Debt to assets (LEV) = Total debt / total assets	$LEV_{post} < LEV_{pre}$

I use local currency data in my performance measurements. Whenever possible, the ratios include nominal data in both the numerator and denominator. In computing sales efficiency and net income efficiency, I deflate the sales revenue data using the appropriate consumer price index (CPI) values taken from the World Development Indicators Database of World Bank, and aggregating across companies, I normalize each year's observation relative to sales efficiency in year 0 (the year of restructuring). A similar procedure is employed to compute net income per employee.

My initial tests follow the techniques of Megginson, Nash, and Van Randenborgh (1994). To determine post-restructuring performance changes, I utilize a matched pair methodology (i.e., compare pre- and post-restructuring results). I begin by computing empirical proxies for every company over a seven-year period: the three years before through the three years after restructuring. And then, I calculate the mean value of each variable for each firm over the pre- and post-restructuring (pre-restructuring = year -3 to -1; post-restructuring = year +1 to +3). Since the year of restructuring (year 0) includes phases of both state and private ownership, I exclude year 0 from my mean calculations, though I examine several variables that are normalized relative to that firm's value in year 0 (variable value in year 0 equals 1.00).

Having computed pre- and post-restructuring means, I use the Wilcoxon signed-rank test as my principal method of testing for significant changes in the variables. This procedure tests whether median difference in the variable values between pre- and post-restructuring samples is zero. I base on my conclusions on the standardized test statistical Z, which for samples of at least 10 follows approximately a standard normal distribution. In addition to Wilcoxon test, I utilize a (binomial) proportion test to determine whether the percentage (p) of firms experiencing changes in a specified direction is greater than would be expected by chance (typically testing whether p =0.5).

5.3.3. Econometric Estimation Model

The multivariate techniques was taken to examine the relationship between the attitudes of managers toward CSR and their behaviours; and relationship between CSP and financial performance in restructuring. Correlation and regression are statistical procedures appropriate for identifying these relationshops between a dependent variables and on or more independent variables.

I first investigate which variables have the strongest relationship with the dependent variable by using partial correlation , second, I work out which variable has the greatest impact on dependent variable by using partial regression, third, I use a whole set of independent variables to predict the dependent variables by using logistic regression.

The partial porrelations procedure is used to compute partial correlation coefficients between attitudes, age and education of managers and CSR indicators while controlling for for the effects of firm's size, industry, ownership and location. The focus is what factors might influence managers' attitudes toward CSR and whether socially responsible value-oriented managers attach more importance to social issues in restructuring.

The multiple regression equation is developed to estimate the effects of managers' attitudes on managers' CSR behaviours controlling for age and education of managers:

$$Y_i = \alpha + \beta_{YX1.X2} \times X1_i + \beta_{YX2.X1} \times X2_i + \varepsilon_i$$

Where α is regression intercept; Y is the dependent variable of managers' behaviours, $\beta_{YX1.X2}$ is partial regression coefficient, the change in Y for a unit change in X1 controlling for X2, and analogously for $\beta_{YX2.X1}$, ε is the error term.

Logistic regression is useful for situations in which researchers want to be able to predict the presence or absence of a characteristic or outcome based on values of a set of predictor variables. It is similar to a linear regression model but is suited to models where the dependent variable is dichotomous. Logistic regression coefficients can be used to estimate odds ratios for each of the independent variables in the model.

In this study, logistic regression is used to examine the impact of socially responsible performance on firm's financial performance in post-restructuring based on values of a set of predictor variables. For a binary response Y and an explanatory variable X, let $\pi(x)$ denote the probability of being in high CSP, when X take value x. This probability is the parameter for the binomial distribution. The logistic model has linear form for the logit of the probability,

$$\operatorname{logit}[\pi(x)] = \alpha + \beta_1 x_1 + \beta_2 x_2 + \ldots + \beta_k x_k$$

The detail descriptions of the variables and equations will be given in Chapter 6 and Chapter 7.

Chapter 6 The Effects of Managerial Values on Socially Responsible Restructuring

6.1. Introduction

This Chapter presents the empirical study on how the managers perceive and interpret CSR in the context of China's economic reforms, and especially, whether managers with socially responsible value-oriented tend to undertake restructuring in a more socially responsible manner. The data for this analysis was collected by the survey conducted in 2003-2004 (see Chapter 5). I believe that the study in this area is particularly important, as it will provide greater insight on the extent to which CSR has developed and is interpreted in recent years in China. By comparing with other studies in this area, this research will also show the difference in interpretation and perceptions of CSR in the different cultural and economic context between China and other countries.

6.1.1. Attitude - Behaviour Theory

Many studies argue that the attitudes and intentions of top management are central to the strategy process of a firm. Katz (1960) claims that attitudes provide people with a framework within which to interpret the world and integrate new experiences. Ajzen and Fishbein (1977) further suggest that by understanding an individual's attitudes toward something, one can predict that individual's "overall pattern of responses" to the object. They argued that a single behaviour is determined by the intention to perform the behaviour in question. A person's intention is in turn a function of his attitude towards performing the behaviour. Not only will, therefore, managerial values frame the issues evaluation process but they are also likely to directly shape the issue management process.

Wood (1991a) underscores individual or managerial intentions as the motivators of socially responsible behaviour, the management of stakeholder expectations as an integral part of the process, and an emphasis on programmes and policies as the primary outcomes of those processes, an assessment of a manager's attitudes toward CSR, then, may provide an indication of the manager's predisposition to respond in a particular way to CSR. One striking case could illustrate their arguments. It is reported in Europe, the French-based food group Danone has long had an image as a "socially responsible company". Antoine Riboud, head of the company until 1996, cultivated a reputation as a "socially-oriented boss". He and his successors always live up to the socially responsible-oriented value, although since late 1990s, Danone Group has undergone restructurings in different sectors, the restructurings have been undertaken in a more socially responsible manner. Danone becomes the model of socially responsible restructuring in Europe.

6.1.2. Changing Conduct and Moral of Doing Business in China

In China, CSR has been introduced to practitioners and Chinese academic researchers only in recent years. The introduction is driven by both external and internal factors. Externally, in recent few years, particularly after China's entry into WTO, more multinational corporations have expanded their businesses in China, with the rise in trade, the requirements for good quality of products and services are increased, and hence the attention of trading with China has caused the tension between business practice based on profit-making and anti-capitalist campaign promoting operation standards, best business practices, western values and moral standards. Internally, more Chinese corporate activities have expanded into the global market; it is imperative for managers to adapt to different business culture when the firm operates in other countries. Such cultural expectations from host countries include corporate citizenship behaviour of their firms, dealing with different culture-based corporate conduct for managers in international business. It is important for these enterprises to better understand and anticipate the expectations that different host countries may have for the corporate social responsibility in the context of international business. These companies may serve as change agents to promote ethical and responsible business behaviour in China.

CSR has been of major concerns in China's society since the economic reform, especially in recent decade. It is argued that since economic reform, role of the Chinese businesses in the new division of social responsibilities has been changing, but often changing in the opposite direction to that prescribed by advocates of increased CSR. The goal of economic freedom and individual wealth has grown rapidly in China and has replaced the former Confucian and Maoist values. More and more attention is paid to economic gain, while balancing profits and moral standards is becoming less important. These changes have led to and influenced CSR and definition of key stakeholders. More and more Chinese business people are generally motivated by profit and view profitability as the primary overriding goal. Professional morality has weakened, social responsibility has dimmed and the phenomenon of money-worship has grown. Problems have grown with over-stressing material interests, putting profit before everything. Under increasing pressure from market competition, enterprises may pay too much attention to economic gains and leave loopholes in balancing profits and moral standards.

Chinese SOEs are increasingly liberated from welfare provisions and allowed to get down to profit maximization. Some of the most economically dynamic sectors of the economy, such as the nominally "collective" rural industries have driven in an almost complete unregulated environment. Many of these frontier industries have been highly polluting and have offered low wages and minimal health and safety standards to non-unionized rural migrants, of whom there is nonetheless a steady supply. Such industries have been highly profitable (Young and MacRae 2002). The paradoxical phenomenon is that the more profits people are making, the less social responsibility they are assuming. The integrity and ethics of managers have been questioned, and it leads the heated debate with regard to whether the corporate responsibility to society should be one of the most important standards to assess firm's performance.

6.2. Descriptions of Variables and Analysis Techniques

I start with the assessment of attitudes of managers toward CSR. The managers were asked to respond to the questions in the survey. The questions consist of a mixture of 'favourable and unfavourable' statements to which managers are asked to express their extent of agreement and disagreement. A favourable response to the attitudes gets a high score, thus for 'positive statements' 'strongly agree' gets a high score, while for 'negative statements', 'strongly disagree' gets high score. Then, each score of each item is added up to obtain scale score. The scale score was used to assess the extent of managers' attitudes to which managers were in favour of or against CSR, and the extent of managers' behaviours to which acted in a more socially responsible manner in the restructuring activity. This Chapter focuses on analysis of following five areas:

(1) Attitudes of managers toward CSR: In the structured survey, the managers were asked to express their views on whether they agree or disagree on the statements of CSR. For ease of discussion, the factor analysis was used to reduce data size and in particular, identify the number of underlying factors which can explain most of the variance observed in the eleven variables. Attempt is also made to determine what factors might influence managers' attitudes by employing regression analysis.

(2) Managers? orientation to stakeholder groups: The orientation of managers to the stakeholder groups were examined to identify which stakeholders groups are perceived as the primary stakeholders in China, and to examine the extent to which managers' orientations influence their relationships with stakeholders. The stakeholders in the survey include shareholders, employees, government, general public, community, and business partners.

(3) Perceptions of socially responsible restructuring: The different cultural and economic context may lead to various perceptions of socially responsible restructuring. In this study, the managers were asked to assess what strategies and practices were relatively more socially responsible in restructuring in China.

(4) Determinants of CSP in restructuring: The respondents were asked in the survey to rank what dimensions are the main determinants for measuring socially responsible performance in restructuring. The indicators were developed on the basis of the extent to which employees involvement, government involvement, open communication, innovative production initiatives, and provision of social support programme, workforce reduction and labour disputes arising from the process of restructuring

(5) Relationship between managers? attitudes and CSR behaviours in restructuring: Against the attitudes and behaviours theory, the relationships between managers' attitudes and their behaviours are examined to test the hypothesis: whether managers who are more in favour of CSR engage in a more socially responsible restructuring.

The multivariate analysis will be employed to investigate whether the attitudes of managers toward CSR are influenced by some factors such as firm's size, ownership, industry, location that a firm operates, manager's age and education level (equation 1). The focus is placed on testing the hypothesis with regard to whether socially responsible value-oriented managers pay more attention to social issues arising from restructuring activities than other managers (equation 2). The variables for the analysis are presented in Table 6-1. The regression equations are developed as follows:

$$CSRATD = \beta_1 + \beta_2 SIZE + \beta_3 OWNSHIP + \beta_4 IND + \beta_5 LCTN + \beta_6 AGE + \beta_7 EDU + \varepsilon \quad (1)$$

$$CSRBHV = \gamma_1 + \gamma_2 SIZE + \gamma_3 OWNSHIP + \gamma_4 IND + \gamma_5 LCTN + \gamma_6 AGE + \gamma_7 EDU + \gamma_8 CSRATD + \varepsilon \quad (2)$$

Where, in equation (1) dependent variable CSRATD represents the ratings of manager's attitudes toward CSR, other variables in the equation include control variables: firm' size (SIZE), ownership (OWNSHP), industry (IND) and location (LCTN); the independent variables cover ages (AGE) and education (EDU). ε is the error term. In the equation (2), the dependent variable CSRBHV refers to the managers' CSR behaviour, the rest of the variables are the same as the equation (1).

I omitted gender variable in the regression analysis since there was only one female respondent in the survey (see Table 5-4 in Chapter 5), it doesn't make sense to analyze the difference against gender.

Table 6- 1 Definitions of Explanatory Variables for Relationships between Attitudes and Behaviours

	Proxy for	Empirical Definition
		Control Variables
SIZE	The size of firm	Indicator variable with value = 1 if a firm is large; 2 = medium-sized, 3 = small.
LCTN	Location (Geographic Indicator)	Indicator variable with value = 1 if a firm is located in North China; 2 = South China, and 3 = East China, and 4 = West China.
IND	Industry sector	Industry is grouped into 7 categories. Indicator variable with value = 1 if firm is from Chemical; 2 = motor; 3 = electronic and optical; 4 = machinery; 5 = construction; 6 = electricity and power, and 7 = transportation and storage.
OWNSHP	Ownership	Indicator variable with value = 1 if a firm is state-owned, else = 0.
		Independent Variable
AGE	Age of respondents	Indicator variable with value = 1 if manager's age is between 35 and 45; 2 = 46 -55; and 3 = 56-65.
EDU	Education level	Indicator variable = 1 if manager's education is below university; 2 = university and 3 = above university.
CSRBHV	Ratings of CSR behaviours	Indicator variable with value = 1 if a manager's behaviour is more socially responsible, else 0.

		Dependent Variable
CSRATD	Ratings of attitudes toward CSR	Indicator variable with value =1 if a manager is in favour of CSR, 0 = against CSR.

6.3. Findings and Analysis

6.3.1. Attitudes of Managers toward CSR

The eleven statements were selected to examine the perceptions of managers toward CSR. In the survey design, the response to the questions was scored consistently, i.e. a favourable response to the attitude gets a high score. the statements in the structured questionnaires are ranked on a five-point interval scale which ranges from (5) strongly agree to (1) strongly disagree, for positive statements "strongly agree" gets a high score, while for negative statements also gets a high score. The scores for each question were then added up to provide each respondent with overall score for the set of questions (scale score), This scale score is taken to indicate a respondent "position" on the abstract dimension which the individual questions are intended to tap. Thus, to create an interpretable scale score, all the items were coded in the same direction, the existing variables were recoded so that the scores on the scales were compared and so that the items with each of the scales were combined to form the scale in the first place. A high score indicated the executives and managers are in favour of CSR while a low score indicated managers against CSR. The statistical analysis in Table 6- 2 revealed the result of all the eleven variables.

Table 6- 2 Statistical Description of Variables for Measuring Attitudes (%)

Statements	N	5	4	3	2	1
1.Engagement of a firm in socially responsible actions does not conflict with pursuit of profit	83	27.7	30.1	9.6	28.9	3.6
2.Business will participate more actively in social responsibility in prosperous economic times than in recession	83	2.4	6.0	10.8	45.8	34.9
3.A business that wishes to capture a favourable public image will have to show that it is socially responsible	83	49.4	41.0	3.6	6.0	0.0
4.There is no difference between involvement of a firm in socially responsible activities and public relations positioning	83	7.2	47.0	22.9	16.9	6.0

5.Business already has too much social power and should not engage in social activities that might give it more	83	4.8	26.5	20.5	27.7	20.5
6.If business is more socially responsible, it will avoid additional regulations of the economic system by government, and reduce restricts in firm's operation	83	4.8	20.5	28.9	39.8	6.0
7.Involvement by business in improving its local community's quality life will also improve long run profitability	83	22.9	49.4	18.1	8.4	1.2
8.A firm perceived as high in social responsibility can face relatively low level of industrial conflicts	83	18.1	48.2	13.3	16.9	3.6
9.High social responsibility can put a firm at an economic disadvantage compared to less socially responsible one	83	9.6	57.8	16.9	13.3	2.4
10.Socially responsible activities can improve a firm's standing with bankers, and access sources of capital	83	3.6	36.1	30.1	26.5	3.6
11.Socially responsible activities can improve a firm's standing with investors, and reduce financial risk	83	6.0	36.1	32.5	20.5	4.8

Note: 5 = strongly agree, 4 = agree, 3 = neutral, 2 = disagree, and 1 = strongly disagree

For ease of discussion, I attempt to categorize all the questions (eleven statements). I employ the factor analysis with a principal components extraction to reduce the data size. The results of the factor analysis are shown in Table 6-3. I found that the first component is most highly correlate with regulations of economic system by government (factor loading .750), bankers (.690) and with investors (.803). CSR with investors is a better representative, however, because it is less correlated with the other three components. The second component is most highly correlated with public image (.595), communities (.801) and industrial conflicts (.793). The third component is most highly correlated with profits (.718), economic performance (.718) and social power (.651), and the fourth is highly correlated with public relations (.818). This suggests that I can focus on these four factors in further analyses.

Table 6- 3 Results of Factor Analysis for Attitudes towards CSR

Variable	Factor 1	Factor 2	Factor 3	Factor 4
1.Engagement of a firm in socially responsible actions does not conflict with pursuit of profit	.197	.133	.718	-.015
2.Business will participate more actively in SR in prosperous economic times than in recession	.024	-.090	-.744	.427
3.A business that wishes to capture a favourable public image will have to show that it is socially responsible	.412	.595	.043	-.040
4.There is no difference between involvement of a firm in socially responsible activities and public relations positioning	-.101	.040	-.047	.818
5.Business already has too much social power and should not engage in social activities that might give it more	.216	-.074	.651	.306
6.If business is more socially responsible, it will avoid additional regulations of the economic system by government, and reduce restricts in firm's operation	.750	-.136	.315	.187
7.Involvement by business in improving its local community's quality life will also improve long run profitability	.196	.801	-.006	.113
8.A firm perceived as high in social responsibility can face relatively low level of industrial conflicts	-.201	.793	.187	-.203
9.High social responsibility can put a firm at an economic disadvantage compared to less socially responsible one	.198	.401	-.101	-.441
10.Socially responsible activities can improve a firm's standing with bankers, and access sources of capital	.690	.348	.156	-.337
11.Socially responsible activities can improve a firm's standing with investors, and reduce financial risk	.803	.229	.079	-.260

Extraction Method: Principal Component Analysis. Rotation Method: Varimax with Kaiser Normalization.

I labelled the four factors as indicated in Table 6-4. It shows the factor loadings, mean of each statement, and weighted score. Factor 1 mainly deals with the relationship between CSR and constituencies such as government, bankers and investors. Factor 2 is concerned with firm's relationship with the public image, local community, and industrial relations, which could be the contribution to long-term financial performance. Factor 3 is concerned with the relationship between CSR and firm's economic performance. Factor 4 is mainly concerned with whether CSR and public relation campaign is linked.

Table 6- 4 Statistical Description of Factor Analysis of Attitudes towards to CSR

	Factor Loadings	*Mean*	*Weighted Score*
Factor 1- Firm with CSR can improve its standing with Constituencies		3.29	2.46
If business is more socially responsible, it will avoid additional regulations of the economic system by government, and reduce restricts in firm's operation	.750	3.59	2.69
Socially responsible activities can improve a firm's standing with bankers, and access sources of capital	.690	3.10	2.14
Socially responsible activities can improve a firm's standing with investors, and reduce financial risk	.803	3.18	2.55
Factor 2 - CSR produces better environment for business to grow		3.93	2.84
A business that wishes to capture a favourable public image will have to show that it is socially responsible	.595	4.34	2.58
Involvement by business in improving its local community's quality life will also improve long run profitability	.801	3.84	3.08
A firm perceived as high in social responsibility can face relatively low level of industrial conflicts	.793	3.60	2.85
Factor 3 - CSR and Economic Performance are mutual benefit		2.72	1.98
Engagement of a firm in socially responsible actions does not conflict with pursuit of profit.	.718	3.49	2.51
Business will participate more actively in SR in prosperous economic times than in recession	.744	1.95	1.45
Factor 4 - CSR = or ≠ Public Relations		3.33	2.72
There is no difference between involvement of a firm in socially responsible activities and public relations positioning	.818	3.33	2.72

Note: 1 = strongly disagree through 5 = strongly agree.

Table 6-4 presents the factor loading, means and weighted scores. The Factor 1 revealed managers' perceptions of relationship between a firm's socially responsible performance and constituencies. The means of Factor 1 (3.29) does support the arguments of previous studies, which is that socially responsible activities may improve a firm's standing with such important constituencies as banks, government and investors. In particular, the managers tend to rank the relationship with government as the most important factor (3.59). It is argued that if business is more socially responsible, it will avoid additional regulations of the economic system by government, and reduce restricts in firm's operation. This is in conformity with modern stakeholder theory (Cornell and Shapiro 1987b), which contends that the value of a firm depends on the cost not only of explicit claims but also of implicit claims. If a firm does not act in a socially responsible manner, parties to implicit contracts concerning the social responsibility of the firm may attempt to transform those implicit agreements into explicit agreements that will be more costly to it. For example, if a firm fails to meet promises to government officials in regard to actions that affect the environment (dumping, etc.) government agencies may find it necessary to pass more stringent regulations, constituting explicit contracts, to force the firm to act in a socially responsible manner. Moreover, socially irresponsible actions may spill over to other implicit stakeholders, who may doubt whether the firm would honour their claims. Thus, firms with an image of high CSR may find that they have more low-cost implicit claims than other firms and thus have higher financial performance (Cornell and Shapiro 1987b).

The statistical analysis also shows that CSR can create better environment (e.g. public image, communities and industrial relations) for firms to grow. The means of Factor 2 (3.93) concerning CSR and business environment indicates that a firm with high CSR can capture a favourable public image, which is closely associated with firm's long-term self-interest, and may gain more customers, better employees and other benefits; and face relatively few labour problems. The result of analysis shows that respondents contend that a business that wishes to capture a favourable public image will have to show that it socially responsible (4.34); involvement by business in improving its local community's quality life also improve long-term profitability (3.84), and a firm perceived as high in social responsibility can face relative low level of industrial issues (3.60).

The questions examining managers' attitudes toward the relationships between CSR and profitability were asked in the survey, which are: whether the exercise of CSR is inconsistent with the profitability; and whether business participates more actively in social responsibility in prosperous economic times than in recession. In response to the first positive statement, the means (3.49) in Table 6-4 shows that managers agreed that the CSR is consistent with pursuit of profits. This argument shows that a better society produces a better environment for businesses; in the meanwhile, spending money for social programmes will actually result in more profit for the business. However, there is a small proportion agreed that businesses' function is to maximize profits, and firm should concentrate on business. This argument is in line with the classical economic doctrine of profit maximization, which argues that economic values are the sole criteria used to measure success. The manager is the agent of the stockholders, and all of his decisions are controlled by his desire to maximize profits for them. Responding to the second negative argument, the means (1.95) reveals that managers don't agreed that the businesses will actively participate in socially responsible activities, only in prosperous economic times, not in recession. This implies that being a socially responsible firm should assume the social responsibility at any time.

In terms of the relationship between CSR and Public Relations, the means (3.33) shows that respondents agreed that there is difference between CSR and public relations positioning. The low means also indicate that some of the respondents regard CSR as a kind of public relations. Obviously, there was a slight difference between the two groups; it indicates that most of Chinese managers haven't a clear idea of what is CSR and what is public relations positioning. The three fundamental principles could be used to distinguish the two concepts. The first is to judge whether the socially responsible activities contribute to social benefits, second is whether socially responsible activities include much substance of a firm business.

Table 6- 5 Statistical Results of CSR Attitude Ratings

Ratings	*N*	*%*
In favour of CSR	49	59
Against CSR	34	41
Total	83	100.0

The result of attitudes ratings in Table 6-5 shows us that over 59% of managers are in favour of CSR, and 41% against CSR.

6.3.2. Managers' Stakeholder Orientation

As is defined in Chapter 4, stakeholders refer to all groups who are affected by, or that can affect, an organization's decisions, policies, and operations (Post, Lawrence, and Weber 2001). Although relevant stakeholder groups will vary from firm to firm over time, Freeman (1984) has proposed a "generic set" of stakeholder groups as a starting point for a more thorough analysis. This set comprises stockholder, customer, employees, managers, government, and community groups. On the basis of this defined stakeholders, and in the context of Chinese firms, I chose seven "general stakeholder groups", which are slightly different from Freeman's generic set in this research: shareholder, employees, customers, government, general public, community, and business partners. Each stakeholder group presents a different and often conflicting set of expectations to the organization (Ansoff 1984, Freeman 1984). Shareholders or owners of the firm have an obvious stake in the organization and an interest in its financial performance; customers focus on the perceived value delivered by goods relative to their cost; employees have expectations of management and must be induced to cooperate on behalf of the firm (Barnard 1968); community and governmental influences shape philanthropic and political activities that arise directly from the complex relationships between the organization and environment (Preston 1978). Government, for example, exerts its power by passing laws or writing new regulations with which business is expected to comply.

The survey investigates extent to which the orientation of managers to seven stakeholder groups has any difference, and identifies which stakeholder groups might be the primary stakeholder in China. The managers were asked to answer the following two questions which are: (a) to what extent, do the impact stakeholders groups have on your firm's public image/reputation? (b) to what extent the relationship does your firm have established with the stakeholder groups? Each item used a 5-point Likert-type response scale indicating the relative degree of impact, relationship and as well as importance attached to the specific stakeholder-oriented activity. The statistical result is shown in Table 6-6 and 6-7.

Table 6- 6 Results of Survey on Impact of Stakeholders on Firm's Reputation

Stakeholder Groups	*No*	*To great extent*	*To some extent*	*To little extent*	*Not at all*
Shareholders	83	36.1	47.0	12.0	4.8
Customers	83	55.4	34.9	7.2	2.4
Employees	83	33.7	57.8	7.2	1.2
Business partners	83	19.3	62.7	16.9	1.2
The general public	83	26.5	44.6	27.7	1.2
Local communities	83	7.2	62.7	26.5	3.6
Governments	83	61.8	37.3	10.8	0.0

Table 6- 7 Results of Survey on Firm's Relationship with Stakeholders

Stakeholder Groups	*No*	*Best*	*Better*	*Good*	*Bad*	*Not at all*
Shareholders	83	30.1	51.8	13.3	1.2	3.6
Customers	83	26.5	63.9	9.6	0.0	0.0
Employees	83	22.9	62.7	14.5	0.0	0.0
Business partners	83	16.9	63.9	16.9	1.2	1.2
The general public	83	14.5	53.0	30.1	0.0	2.4
Local communities	83	4.8	56.6	33.7	1.2	3.6
Governments	83	25.3	56.6	16.9	0.0	1.2

Corporate image is a function of organizational signal which determine the perceptions of various stakeholders regarding the actions of an organization. Because of its relations to actions of an organization, image has been studied as an indicator of the social performance of the organization. Image perceptions are critical to both the stakeholders and organization because they influence market transactions. Research has consistently demonstrated that corporate image is related to stakeholder decisions about the organization such as consumers' perceptions of price level for goods and services (Klein and Leffler 1981), job seekers' decisions to apply for employment (Gatewood, Gowan, and Lautenschlager 1993), investors' decisions to invest in the firm (Milgrom and Robert 1986), and employees' attitudes and behaviours toward their organization (Dutton and J.M.Dukerich 1991; Richardson, Welker, and Hutchinson 1999).

The result of statistical analysis in Table 6-6 shows that the managers regarded government (61.8%), customers (55.4%), shareholders (36.1%) and employees (33.7%). as the most influential stakeholder groups and followed by the general public (26.5%) business partners (19.3%). It was also found that local community has less influence on firm's public image. Table 6-7 reveals that majority of respondents highly ranked their relationships with shareholders (30.1%), customers (26.5%), government (25.3%) and employees (22.9%), and moderately with business partners and the general public. The local community was again ranked as the lowest. By comparing the two results, it is interesting to find that the managers who attach the importance to the stakeholder groups intend to establish good relationships with the same stakeholders. This implies that the greater impact the stakeholders have on firm's public image/reputation, the more importance the executives and managers may attach to the same stakeholders, and in turn, they intend to establish better relationships with them.

The results reveal that designated responsibility for four stakeholder groups: government, customers, shareholders and employees, as the most important social responsibility. For other stakeholders, managers placed business partners and general public as the second and third important stakeholder groups. In China, the degree to which firms have the relations with the stakeholders depends on the importance of the stakeholders' contribution to firm's economic performance. On the basis of the results of survey, we are able to articulate the four concentric circles which define the relations between firm and stakeholder groups. The firm is sited in the centre of the circle, and then the more important the stakeholder groups are, the closer they are to the firm. In this case, the government and customers are located in the inner circle, shareholders and employees, business partners in the intermediate circle, and the general public and local community in outer circle.

If we compare the results with the attitudes of managers in other countries, we can find the difference in different regions. According to the 5th Annual Global CEO survey by PricewaterhouseCoopers (2001), in North America, 93% of CEOs regard responsible actions toward all stakeholders as a key influence on their firms' social reputation. The CEOs recognize that corporate social reputation has less to do with earnings and more to do with reputation across a broad array of stakeholders. In Europe, the foremost issue is provision of sound working environment (93%), followed at a slight distance by responsibility to all stakeholders (82%), and ensuring shareholder value (67%). In France and Germany, the survey found that the firm serves the interests of its employees; provide employees with an occupation, but also with extensive benefits, a pleasant work environment, and a place where social interactions are cultivated (Maignan and Ferrell 2003).

The results of the survey were shown in Table 6-8 about the perceptions of managers to the socially responsible behaviours. The result indicates that over 60 % of respondents strongly agree that responsibility to government, customers, environment, employees and shareholders are more important. However, actively participating in social benefit activities (communities) was regarded as the least important activity.

Table 6- 8 Results of Survey on Perceptions of Socially Responsible Behaviour

Statements	*N*	*5*	*4*	*3*	*2*	*1*
1. Complying with state law and being a good tax payer (Government)	83	72.3	25.3	2.4	0.0	0.0
2. Provision of quality products and services for customers (Customers)	83	67.5	26.5	6.0	0.0	0.0
3. Improving environmental quality and pollution control (Environment)	83	63.9	32.5	3.6	0.0	0.0
4. Provision of a healthy and safe working environment (Employees)	83	61.4	33.7	4.8	0.0	0.0
5. Creating value for company shareholders (Shareholders)	83	60.2	32.5	6.0	1.2	0.0
6. Doing business with its partners with integrity (Business partners)	83	45.8	48.2	6.0	0.0	0.0
7. Actively participating in social benefit activities (Communities)	83	24.1	59.0	15.7	1.2	0.0

Note: 5 = strongly agree, 4 = agree, 3 = neutral, 2 = disagree, and 1 = strongly disagree.

6.3.3. Perceptions of Socially Responsible Restructuring

The concept of socially responsible restructuring is defined in Chapter 1 and 4, as restructuring a firm undertakes to balance and take into consideration of the interests and concerns of stakeholders who are affected by the changes and decisions, involve affected stakeholders in the process of whole restructuring through open and effective communications and consultation, and adopt social support programme to assist those who are affected after restructuring.

Against the definition of SRR, nine representative statements were identified, which were derived from prior studies and literatures measuring socially responsible performance in restructuring. The respondents were given the structured questionnaires and asked to express their perceptions of which actions or practices are more socially responsible in restructuring. Each item used a 5-point Likert-type response scale indicating the relative degree of importance they attached to the specific determinant of socially responsible restructuring. This scale ranged from 5 (strongly agree) to 1 (strongly disagree). Nine variables were grouped into three categories: 1) prior to restructuring including restructuring announcement; involvements of employees, trade unions and local communities; and communications; 2) in the process of restructuring including internal support programme, provision of severance package for earlier retirement; 3) post-restructuring including continuous financial support and redeployment of terminated and redundant workers (see Table 6-9).

The results of statistical analysis in Table 6-9 reveal that in the prior restructuring, over half of the managers strongly agree that it's important to keep the stakeholders who are influenced by restructuring informed of restructuring decision in very early stage. Open communications with employees (47.6%) was also regarded as the most important practice of socially responsible restructuring, and followed by seeking inputs from stakeholders (39.%). In the second stage, the respondents strongly agree with provision of supports for business start-up (42.7%), and outplacement services (42.7%). In the post-restructuring, it's agreed that it's necessary for a firm to continue offering salary and benefits to terminated employees for a period time in order to allow reasonable time for job search (84.1%).

Table 6- 9 Statistical Result of Perceptions of Socially Responsible Restructuring

Statements	*N*	*5*	*4*	*3*	*2*	*1*
1. Prior to restructuring						
Announcements of restructuring decision in very early stage	82	56.1	26.8	12.2	3.7	1.2
Seeking inputs from employees, trade unions and local communities	82	39.0	53.7	6.1	1.2	0.0
Open communications with employees about the restructuring event	82	47.6	48.8	3.7	0.0	0.0
2. During restructuring						
Assisting employees in obtaining government benefit and job training support, job search allowance	82	28.0	61.0	8.5	2.4	0.0
Providing severance benefit package for voluntary early retirement	82	32.9	54.9	11.0	1.2	0.0
Encouraging and supporting employees to start up their own businesses	82	42.7	47.6	7.3	2.4	0.0
Providing internal or external outplacement service such as training for employability, job counselling, financial planning and information on government benefits	82	42.7	48.8	8.5	0.0	0.0
3. After restructuring						
Continuing to offer salary and benefits for a period time in order to allow reasonable time for job search	82	31.7	52.4	14.6	1.2	0.0
Organizing the transfer of redundant and laid-off employees to other units, giving them priority for job vacancies	82	30.5	45.1	20.7	2.4	1.2

Note: 5 = strongly agree, 4 = agree, 3 = neutral, 2 = disagree, and 1 = strongly disagree.

In conclusion, I found that the stage of prior to restructuring was ranked as the most important, and followed by duration of restructuring and post-restructuring. It also indicates that before implementation of restructuring, it is important to communicate openly and sincerely to employees about restructuring decision and other information; announce restructuring decision in very early stage; and seek inputs from employees and trade unions, and local communities. During the process of restructuring, practices should be taken to encourage and support employees to start up their own business; provide severance benefit package for voluntary early retirement and assist employees in obtaining government benefit and job training support, job search allowance; and also internal and external outplacement shall be provided such as training for employability, job counselling, financial planning and information on government benefits. After restructuring, the firm shall continue to offer salary and benefits for a period time in order to allow reasonable time for job search; organize the transfer of redundant and laid off workers to other units giving them priority for job vacancies.

6.3.4. Socially Responsible Behaviour in Restructuring

Many researchers have attempted to measure CSP employing various ways such as forced-choice surveys (Aupperle 1991; Aupperle, Carroll, and Hatfield 1985b), the Fortune reputation index and social responsibility index (McGuire, Sundgren, and Schneeweis 1988), content analysis of firm's reports and documents (Wolfe 1991), behavioural and perceptual measures (Wokutch and McKinney 1991), and case study (Clarkson 1991), however, it's difficult to measure it consistently because of the limitations. Now, researchers use social data from Kinder, Lydenberg, Domini (KLD) & Co. to assess CSP. For example, since 1996, the Journal of Business Ethics ranks the 100 Best Corporate Citizenship based on KLD social index. It looks at the strength and concerns in the areas of environment, community relations, employees relations, and diversity and customer relations.

In this study, I used the forced-choice survey as a tool to measure socially responsible performance in restructuring undertaken by a firm. In the survey, the managers were asked to answer pre-determined questions concerning the measurement of CSP, which are used as index of CSP in restructuring. A literature review was conducted to select CSP dimensions in restructuring, and then I screened most of the items from the previous research and literature, combining the result of evaluation of importance of determinants of socially responsible performance in restructuring I conducted in the survey, eleven variables in Table 6-10 were identified to be used to measure socially responsible performance in restructuring:

Table 6- 10 Dimensions of Measurement of CSP in Restructuring

Dimensions	*Descriptions*
Employees	The extent to which employees were kept involved in restructuring
Community	The extent to which local community were kept involved in restructuring
Government	the extent to which government were kept involved in restructuring
Communications	The extent to which communications were open to those who were influenced by restructuring.
Production	The extent to which the innovative production were initiated in restructuring.
Downsizing	The extent to which workforce was reduced in restructuring.
Social support	The extent to which social support programmes were provided for redundant/lay-offs.
Labour disputes	The extent to which labour disputes took place in restructuring actions
Deployment	the extent of laid-off/redundant workers deployed after restructuring
Restructuring approaches	the extent of approaches employed in the restructuring
Social functions	The extent of social functions split off from firms after restructuring

These dimensions and the definitions are based on criteria used by Casio (2000), KLD' Social Rating Service. The selection of dimensions was influenced by the availability of evaluation data and the fact that these dimensions reflect the social issues that were used in prior research. Each item was ranked on a five-point scale - which meant putting numerals to KLD's ratings, ranging from "major concern" (1) and "concern" (2) on the low side, through a neutral ranking (3), to "strength" (4) and "major strength" (5) on the positive side. Table 6-11 shows the result of means, medians and standard deviations of the eleven dimensions of socially responsible restructuring

Table 6- 11 Statistical Description of Measurement of CSP in Restructuring

Item	Total	Mean	Median	Std deviation
1. the extent of employee involvement	70	4.73	5.00	.563
2. the extent of local community involvement	70	4.31	5.00	.971
3. the extent of government involvement	70	4.20	4.00	.910
4. the extent of communication with employees	70	4.43	5.00	.734

5.	the extent of innovative production initiatives	70	4.44	5.00	.792
6.	the extent of workforce reduction	70	3.83	4.00	1.167
7.	the extent of the social programme provided for redundant/laid-off workers	70	4.70	5.00	.622
8.	the extent of laid-off workers deployed after restructuring	70	4.57	5.00	.693
9.	the extent of labor disputes in the restructuring	70	4.11	5.00	1.043
10.	the extent of approaches employed in the restructuring	70	2.66	3.00	7.00
11.	the extent of social functions split off from firms	70	2.80	3.00	.809

Note: 1 = major concern through 5 = major strength

The most of the dimensions of CSP measurement were served as the index of socially responsible restructuring (SRR), for example, involvement of employees, government, and communities; communication tactics, deployment of redundant workers and social support programme. The statistical analysis of socially responsible performance in Table 14 shows that to the great extent that the restructured firms kept involved of employees (4.73), community (4.31), and government (4.20). Provision of social support programme (4.70) and redeployment of laid-off workers (4.57) were regarded as the most important socially responsible practices after restructuring. The result also shows that development of innovative production strategies such as upgrading or developing new production lines; upgrading of existing production lines, opening of new plant, and redeployment of lay-offs are also very important.

Whether these dimensions are closely relevant to measurement of socially responsible performance, bivariate correlations were used to measure the importance and strength of each variable for the measurement of SRR, and as well the correlations with the overall scores of each company which were computed over the eleven variables. The correlation reported Table 6-12 shows that there is a significant and fairly strong positive correlation between employee involvement (.442) at the .01 level; community involvement (.545) at the .01 level, communications (.598) at the level .01, production initiatives (.579) at the .01 level, workforce reduction (.267) at the level .05, social support programme (.411), redeployment of laid-off/redundant workers (.356) at the level .01, and labour disputes (.273) at the level .05, and the rest of three variables were not significantly correlated with the determinants of socially responsible restructuring, I, therefore, used these eight variables to measure socially responsible performance of enterprise restructuring: the extent of employee involvement; the extent of community involvement; the extent of communications with employees; the extent of innovative production initiatives; the extent of workforce reduction; the extent of social support programme for redundant/lay-offs; the extent of laid-off and redundant workers deployed after restructuring; the extent of labour disputes in restructuring actions.

Finally, I compute overall score of each respondent and added them up, and developed ratings of CSR behaviour in restructuring on the basis of their scores. CSR behaviour ratings were grouped into two categories: higher CSR behavour (53%) and lower CSR behavour (31.3%) (see Table 6-13). In combining CSR behaviour ratings in restructuring and attitude ratings, I will analyze whether the socially responsible values-oriented managers pay more attention to social issues in restructuring than other managers.

Table 6- 12 Statistical Results of CSR Behaviour Ratings

Ratings	*N*	*%*
Higher CSR	44	53.0
Lower CSR	26	31.3
Total	70	100.0

Table 6- 13 Correlations among the Variables of Determinants of Socially Responsible Restructuring

	1	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*
1.Employee involvement									
2.Community involvement	0.185								
3. Government involvement	-0.119	-0.007							
4. Communications	0.321**	0.296*	0.087						
5.Production	0.176	0.363**	0.076	0.517**					
6. Downsizing	0.061	0.087	-0.117	-0.065	0.036				
7.Social support	0.219	0.230	-0.123	0.286*	0.274*	-0.232			
8.redeployment	0.069	0.095	-0.138	0.195	0.219	-0.074	0.571**		
9. Labour disputes	0.128	-0.065	0.082	-0.141	0.008	0.254*	-0.192	-0.011	
10. Approaches	0.018	0.012	0.093	0.069	-0.393**	-0.007	0.051	-0.184	
11.Social functions	-0.185	-0.029	-0.024	-0.024	-0.109	0.040	-0.336*	0.062	-0.174
12. Overall SRR	0.442**	0.545**	0.119	0.598**	0.579**	0.267*	0.411**	0.356**	0.273*

***** Correlation is significant at the 0.01 level (2-tailed).***
**** Correlation is significant at the 0.05 level (2-tailed).***

6.3.5. CSR Activities of Firms

Since the managers attached great importance to CSR, what socially responsible activities have the Chinese firms been involved over the past 3 years?

The result of survey shows that over the past 3 years, the majority of firms have been involved in public welfare activities (86.6%), encouraging employees' voluntary welfare programme (91.5%), improving employee welfare (98.8%), active contribution of tax to government (97.6%), environment protection and pollution control (97.6%), contribution to assist the vulnerable group (82.9%), donation to charitable and public welfare organizations (42.7%) and contribution to cultural and literary programmes (62.2%) (see Table 6-14).

The results imply that the managers allocated more importance to employee welfare and benefits, contribution of tax to government, and environmental protection, and less to corporate philanthropic responsibility (donation and contribution). It seems that the Chinese executives and managers didn't perceive the philanthropic activities as CSR.

Table 6- 14 CSR Activities of firms Involved

	Total	%
1. Organizing or participating in public welfare activities	82	86.6
2. Encouraging employees' voluntary welfare programmes	82	91.5
3. Improving employee welfare (facilities and benefits)	82	100.0
4. Active contribution of tax to government	82	97.6
5. Improving pollution control/environment impact	82	97.6
6. Contribution to vulnerable group	82	82.9
7. Donation to charitable and public welfare organizations	82	42.7
8. Contribution to cultural and literary programmes	82	62.2

6.3.6. Relationship between Manager's Attitudes and Socially Responsible Behaviours

Against the attitudes and behaviour theory, this study intends to investigate relationship between managers' attitudes and their behaviours in restructuring. In the preceding section, the attitudes of managers toward CSR and the dimensions of CSR behaviours were statistically analyzed, in this section, I will use the those results (Table 6-5 and 6-13) to test the hypothesis about the relationship between managers' attitudes and their behaviours, and to identify what factors might influence managers' attitudes toward CSR.

I compute the partial correlation coefficients between attitudes, age and education of managers and CSR indicators while controlling for firm's size, industry, ownership and location. Table 6-15 displays partial correlations matrix of managers' attitudes, age and education of managers and manager's CSR behaviour. The results show that the managers' attitudes have significantly positive relationships with managers' age, education, and CSR behaviour. This implies that managers in favour of CSR may behaviour in a more socially responsible manner in restructuring.

The regression is used to examine effects of the independent variables on managers' attitudes, and the managers' attitudes on CSR behaviours. The regression analysis was also employed to examine effects of age and education on managers' attitudes (controlling for firm's size, industry, ownership, and location).

Table 6- 15 Partial Correlations between Attitude, Age, Education and CSP

	CSRATD	*AGE*	*EDU*	*CSRBHV*
CSRATD	1.000	0.095*	0.020*	0.019*
AGE	0.095*	1.000	-0.522**	0.137*
EDU	0.020*	-0.522**	1.000	0.061*
CSRBHV	0.019*	0.137*	0.061*	1.000

***Correlation is significant at the 0.01 level (2-tailed).*
**Correlation is significant at the 0.05 level (2-tailed).*
Note: Control variables are Firm size, industry, ownership and location

The results of analysis in Table 6-16 shows that the p-value associated with F value is very small (p <.01), it indicates that the independent variables in both regression equations can reliably predict the dependent variables. The first equation shows that age, education and other independent variables can explain about 6.9 percent of variance in managers' attitudes. In the equation (2), the managers' attitudes and other independent variables were found to explain about 4.1 percent of variance in CSR behaviour difference.

$$CSRATD = 1.224 - 0.105*SIZE - 0.016*IND - 0.103*OWHSHP + 0.003*LCTN + 0.082*AGE + 0.049*EDU. \quad (1)$$

$$CSRBHV = .525 - 0.005*SIZE - 0.063*IND + 0.169*OWNSHP - 0.008*LCTN + 0.090*AGE + 0.010*EDU + 0.005*ATD. \quad (2)$$

The first equation tells us that manager's age and education level have the great impact on their attitudes toward CSR. The second equation shows that unit increase in attitudes of managers, a 0.005 increase in CSR behaviour is predicted. This provides some support for hypothesis *H1*, which is the socially responsible value-oriented managers pay more attention to social issues in restructuring than others

Table 6- 16 Regression Analysis of Attitude against CSP

	Independent Variables						
Dependent variables	*SIZE*	*IND*	*OWNSHP*	*LCTN*	*AGE*	*EDU*	*CSRATD*
CSRATD	0.105	-0.016	0.103*	0.003	0.082*	0.049*	
Intercept = 1.224*; *F value* =2.737**; ΔR^2 = 0.069							
CSRBHV	0.005	-0.063	0.169*	-0.008	0.090*	0.010*	0.005*
Intercept= 0.525; *F value* = 3.311**, and ΔR^2 - 0.041							

**Correlation is significant at the 0.01 level (2-tailed).*
**Correlation is significant at the 0.05 level (2-tailed).*

6.4. Conclusion

This Chapter investigates CSR phenomena of the managers' attitudes toward CSR, stakeholders and socially responsible restructuring, and particularly examines the factors that influence the managers' attitudes, and whether managers holding socially responsible values intend to behaviour in restructuring in a more socially responsible way.

The result of the survey demonstrated that a large proportion of respondents (about 60%) have a better understanding of the concept of CSR and are moderately in favour of CSR. It implies that CSR has gained higher awareness among the Chinese managers in recent years, and are willing to engage in socially responsible activities, and integrate CSR in firm's business routine activities.

The survey also illustrates that in the context of current economic development, the managers allocated more responsibilities to such main three stakeholder groups as government, customers and employees, because these groups have great impact on their reputation and the firm's performance. The managers recognize that the benefits of being a good corporate citizenship which enjoys attracting the best employees, winning deep-seated customer loyalty, minimizing lawsuits, and possibly lowering the cost of capital. The managers tend to create harmonious relations with these groups, and provide quality products and services for customers, create favourable working environment for employees, and contribute more tax to government.

The result implies that higher levels of managers' knowledge about both social responsibility issues and the social responsibility records of firms influence managers' socially responsible behaviours. The regression analysis shows that the managers' age and education are the main factors that influence their attitudes toward CSR; the managers who hold highly socially responsible oriented values attach more importance to socially responsible practices, and act in a more socially responsible manner in restructuring.

Chapter 7 Socially Responsible Restructuring and Firm's Performance in the Listed Firms

This Chapter empirically explores the relationship between corporate social performance (CSP) and financial performance (FP) of 318 firms which have undergone restructurings from 1997 to 2003, and to test the hypotheses in Chapter 4 about whether there are positive or negative associations between socially responsible performance and financial performance. In addition, I attempt to further investigate whether the financial performance was improved after restructuring by comparing pre-and post- restructuring financial and operating performance, and to identify the factors which influence changes in financial performance over the same period.

The 318 sampled firms was selected from the firms listed in domestic stock market (Shanghai and Shenzhen Stock Exchanges). The rationale for choosing listed firms for the study is that listed firm is a typical modern corporate, the financial and accounting data are easily available and reliable, it is standardized against the international accounting standard, and comparable. Second, all the sampled firms were transformed from SOEs and partially privatized through ownership restructuring and shareholding reform. After listing in the stock markets, the listed/partially privatized firms have undergone aggressive asset restructuring to configure and optimize industrial structure and improve profitability and efficiency. Third, in the process of transformation and asset restructuring, the social performance and financial performance have been kept recorded by the China Security Regulatory Commission (CSRC), and two Stock Exchanges, where I was able to collect the data for measuring corporate social performance and financial performance. However, the selective bias should be taken into consideration for financial data of listed firms, because falsification and fabrication of financial data take place in listed firms very often.

7.1. Brief description of Statistical Techniques and Variables

The data and variables used for the study have been described in detail in Chapter 5, in this Chapter, I will briefly explain the variables which will be used to estimate the relationship between CSP and financial performance. The variables for measuring CSP in restructuring include information disclosure, ethical and moral issues, workforce reduction (downsizing). The variables for measuring financial performance include return on assets (ROA), return on equity (ROE), return on sales (ROS) and sales growth (SG). The control variables are firm's size, ownership, industry and location, and dependent variables includes CSP and financial performance. CSP and financial performance are also used as independent variables in the regression analysis. Table 7-1 defines these variables and others which are used in the regression analysis.

The multivariate techniques (e.g. OLS model and logistic models) will be used to answer the research questions about the links the relationship between socially responsible restructuring and financial performance. First, I investigate which variables have the strongest relationship with the dependent variable (partial correlation), second, I work out which variable has the greatest impact on dependent variable (partial regression), third, I use a whole set of independent variables to predict the dependent variables (multiple regression).

The first regression equation is developed to estimate the effects of the factors (e.g. firm's size, CSP) on financial performance:

$$FP = \beta_0 + \beta_1 SIZE + \beta_2 OWNSHP + \beta_3 IND + \beta_4 LCTN + \beta_5 INFODC + \beta_6 ENTHML + \beta_7 DWNZ + \beta_8 CSP + \varepsilon \qquad (1)$$

Where the dependent variable FP represents the average financial performance in pre- or post-restructuring, which is measured by return on assets (ROA), return on equity (ROE), return on sales (ROS). The control variables include firm's size (SIZE), ownership (OWNSHP), industry (IND), and location (LCTN). The independent variables include information disclosure (INFODC), ethical and moral issues (ETHML), downsizing (DWNZ), and corporate social performance (CSP), ε is the error term.

Similar to the OLS regression equation, the prediction equation of logistic regression is used to assess whether the four predictor variables, sales growth (SG), firm's size, industry, and ownership, significantly predicted whether or not CSP improved

$$\ln(p/1-p) = \gamma_0 + \gamma_1 SIZE + \gamma_2 OWNSHP + \gamma_3 IND + \gamma_4 SG + \varepsilon \qquad (2)$$

Where p is the probability of being in higher CSP, SG is sales growth defined as percentage increase (or decease) in sales between pre-and post-restructuring periods, and ε is the error term

Table 7- 1 Definitions of Explanatory Variables Used in Regression Analyses

	Proxy for	*Empirical Definition*
		Control Variables
SIZE	The size of firm standardized by the total assets of the firm	Indicator variable with value =1 if it is the large firm (total assets >400 million Yuan), otherwise else 0 (total assets <=400 million Yuan).
LCTN	Location (Geographic Indicator)	Indicator variable with value = 1 if a firm is located in North China, else = 0; North East =1, else = 0; East China = 1, else = 0; Central China = 1, else = 0, South China =1, else = 0, and North West = 1, else = 0.
IND	Industry sector	Industry is grouped into 18 categories. Indicator variable with value = 1 if firm is from retail and wholesale, else =0; transport and storage = 1 else = 0; motor = 1, else = 0; pharmaceutical and biological = 1, else = 0; finance and insurance = 1, else =0; electricity, gas and energy = 1, else 0; construction = 1, else = 0; real estate = 1, else = 0; post and telecommunications = 1, else = 0; petrol and chemical = 1, else = 0; IT = 1, else = 0; food, beverage and tobacco = 1, else=0; textile and leather = 1, else = 0; publishing and media = 1, else = 0; metal and machinery = 1, else = 0; electrical = 1, else = 0; tourism and catering = 1, else = 0, and agriculture, forestry, animal and husbandry = 1, else = 0.
OWNSHP	Ownership	Indicator variable with value = 1 if less than or equal to 30% of shares owned by the government after restructuring, else = 0; mixed ownership (more than 30%, but less than 50%) = 1, else = 0, and state owned (more than or equal to 50%) = 1, else = 0.
		Independent Variable
CSP	CSP ratings	Indicator variable with value =1 if the firm is with lower CSP, 2 = moderate CSP, and 3 = higher CSP.
INFODC	Ratings of information disclosure	Indicator variable with value = 2 if the information disclosed by a firm is well above average; 1 = above average; 0 = average, and -1 = below average.
ETHML	Ethical and moral issues	Indicator variable with value = 5 if a firm has major strength in ethical and moral issues; 4 = strength; 3 = neutral; 2 = concern, and 1 = major concern.
DWNZ	Downsizing	Indicator variable = 1 if a firm has major concern (reduced workforce at over 15%); 2 = concern (10%-15%); 3 = neutral (5%-10%), 4 = strength (less than 5%); 5 = major strength (no reduction or created new jobs).
		Dependent Variable
ΔROE	Return on equity	Average pre- versus post-restructuring change of ROE
ΔROS	Return on sales	Average pre- versus post-restructuring change of ROS
ΔROA	Return on assets	Average pre- versus post-restructuring change of ROA
ΔSG	Sales growth	Average pre-versus post-restructuring change of sales growth
ΔEMPL	Total employment	Average pre- versus post-restructuring change of employment
ΔLEV	Ratio of total debt to total assets	Average pre- versus post-restructuring change of leverage
ΔSALEFF	Sales efficiency	Average pre- versus post-restructuring change of Sales

		efficiency
ΔNIEFF	Net income efficiency	Average pre- versus post-restructuring change of net income efficiency

The third regression analysis is used to examine the determinants that affect the change in financial and operating performance in post-restructuring:

$$\Delta\% = \beta_0 + \beta_1 SIZE + \beta_2 OWNSHP + \beta_3 IND + \beta_4 LCTN + \varepsilon \qquad (3)$$

Where the dependent variable Δ % represents the average pre- versus post-restructuring change in seven performance measures: changes in return on sales (ΔROS), return on assets (ΔROA), return on equity (ΔROE), sales efficiency (ΔSALEFF), net income efficiency (ΔNIEFF), leverage (ΔLEV), and Employment (EMPL). Seven separate regressions are performed, one for each variable.

7.2. Empirical Analysis and Results

7.2.1. Relationship between CSP and Financial Performance

Before I proceed to estimate the relationships between CSP and financial performance, I will analyze whether the CSR measures are unidimensional by using the principal component analysis, and also the relationship between CSP and control variables (firm's size, industry, ownership and location). The result of the analysis of the three CSR performance variables (information disclosure, ethic and moral issues, and workforce reduction) identified one factor (explaining 48.1 per cent of the total variance). That confirms the unidimensionality of all three variables which seem to be manifestations of the same underlying factor, which is CSP – as defined here. Factor scores will be used as a proxy of the overall CSP which will be examined together with the three CSP variables.

Table 7-2 shows that among the four control variables, only location is not correlated with industry and the rest are inter-correlated. The firm's size was found to have a significantly positive relationship with information disclosure (at p = .05), and ethical and moral issues, and overall CSP (at p = .01), however, it is not statistically related with downsizing. Industry sector significantly negatively links to information disclosure and overall CSP (at p = .05). We also find that ownership has a positive relationship with ethical and moral issues (at p =.01), and as well as overall CSP (at p = .05).

The information tells us that the large firms may be more inclined to disclose the information to stakeholders in a socially responsible way, and treat the stakeholders in a more ethical and moral manner. Thus this might result in the large firms with higher overall CSP. Different ownership structure might also influence the degree of CSP.

Table 7- 2 Correlations between Info disclosure, ethical and moral, downsizing, CSR and Control Variables

		1	*2*	*3*	*4*	*5*	*6*	*7*
1	Information disclosure							
2	Ethical and moral	0.394**						
3	Downsizing	0.174*	0.120*					
4	CSP	0.672**	0.741**	0.700**				
5	Firm size	0.183*	0209**	0.79	0.206**			
6	Industry	-0.19	-0.114*	-0.068	-0.110*	-0.154**		
7	Ownership	0.053	0.248**	-0.035	0.142*	0.179**	-0.154*	
8	Location	0.082	-0.086	0.061	-0.014	-0.153**	0.109	-0.148**

*****Correlation is significant at the 0.01 level (2-tailed).***
****Correlation is significant at the 0.05 level (2-tailed).***
Note: Control variables are firm size, industry, ownership and location

7.2.1.1. The Effects of Financial Performance on CSP

This is to investigate whether CSP is positively or negatively associated with financial performance, and how much impact that financial performance has on CSP, and to test the hypotheses: i.e. higher (lower) financial performance leads to higher (lower) CSP (*H2c*), and higher (lower) financial performance leads to lower (higher) CSP (*H2d*).

Before doing so, I compute the partial correlation coefficients by past financial indicators versus CSP indicators. The financial indicators are measured by ROA_{pre}, ROE_{pre}, and ROS_{pre} (average 3-year pre-restructuring performance in 1997-1999). And then, I run the regression to estimate the relationship between financial performance and CSP taking into consideration of the control variables.

Table 7-3 displays partial correlations matrix of financial performance indicators (pre-restructuring) and CSP. Possible effects resulting from a firm's size, industry, ownership and location were controlled for (partialled out). The result reveals that information disclosure has statistically significant and positive relationships with ROA_{pre} (at p=.05), ethical and moral issues are significantly and positively correlated with ROE_{pre} (at p =.05). Overall CSP has significant and positive relationships with both ROA_{pre} (at p=.05) and ROE (at p=.05), but didn't significantly link to ROS_{pre}. This implies that the most of dimensions of CSP are statistically positively correlated with past financial performance of restructured firms.

Table 7- 3 Partial Correlations between CSR and FP
(pre-restructuring 1997-1999)

	Info disclosure	*Ethical and Moral*	*Downsizing*	*CSP*
ROA_{pre}	0.195*	0.088	0.120	0.185*
ROE_{pre}	0.131	0.198*	0.119	0.222**
ROS_{pre}	0.085	0.115	0.053	0.123

*****Correlation is significant at the 0.01 level (2-tailed).***
****Correlation is significant at the 0.05 level (2-tailed).***
Note: Control variables are Firm size, industry, ownership and location

In addition, the regression analysis was taken to estimate the effects of the financial performance (pre-restructuring) (controlling for firm's size, industry, ownership, and location) on the information disclosure, ethical and moral issues, downsizing and overall CSP. The variables entered the regression equation at two steps. At the first step, the control variables, and at the second step, ROA_{pre}, ROE_{pre}, ROS_{pre} were entered. At each step, changes between the consecutive R^2s (ΔR^2s) were estimated. ΔR^2s together with unstandardized regression coefficients (betas) were used to evaluate the size of the independent variables' effects on information disclosure, ethical and moral, downsizing and CSP. The results of analysis in Table 7-4 shows that the p-value associated with F value is very small (.000), it indicates that the independent variables in the regression equation can reliably predict the dependent variables (CSP). The financial performance (ROA_{pre}, ROE_{pre}, and ROS_{pre}) was found to explain about 4.1 percent of variance in CSP difference. The regression equation is as follows:

$CSP = 2.768 + 0.590*SIZE - -0.017*IND + 0.108*OWNSHP + 0.024*LCTN + 0.131*ROA_{pre} + 0.125*ROE_{pre} + 0.001*ROS_{pre}$

The equation shows that every unit increase in past financial performance (e.g. ROA_{pre}), a 0.131 increase in CSP is predicted. This provides some support for hypothesis *H2c*, which is higher (lower) of firm's financial performance leads to a higher (lower) level of CSP in restructuring.

However, the result can't tell whether higher (lower) of financial performance leads to a lower (higher) level of CSP in restructuring (*H2d*), therefore, the logistic regression is used to work out whether the negative association between the two variables exists.

Table 7- 4 Regression Analysis of FP against CSP (Pre-restructuring)

Independent variables	*Dependent Variables*			
	Info disclosure (INFODC)	*Ethical and moral (ETHML)*	*Downsizing (DWNZ)*	*CSP*
Firm size (SIZE)	0.504*	0.649*	0.389***	0.590**
Industry (IND)	0.002	-0.017	-0.023	-0.017
Ownership (OWNSHP)	0.042	0.306*	-0.089	0.108
Location (LCTN)	0.084	-0.029	0.067	0.024
Intercept	0.010	2.339**	3.539	2.704**
F value	1.661	7.803**	1.630	4.954**
ΔR^2_1	0.048	0.091	0.021	0.060
ROA_{pret}	0.194*	0.079	0.093	0.131*
ROE_{pret}	0.133	0.136*	0.062	0.125*
ROS_{pre}	0.091	0.070	-0.061	0.001
F value	1.921*	5.473**	1.626	4.456**
Intercept	0.791	3.272*	3.743	3.407*
ΔR^2_2	0.56	0.050	0.15	0.041
F value	1.921	5.728**	1.596	4.136**
Final intercept	0.013	2.433	3.518	2.768
Final ΔR^2	0.094	0.115	0.035	0.086

***Correlation is significant at the 0.01 level (2-tailed).*
**Correlation is significant at the 0.05 level (2-tailed).*

Logistic regression was conducted to assess whether the predictor variables significantly influence CSP. The outcome (response) variable of CSP is binary: higher CSP or lower CSP. The predictor variables are sale growth, firm's size, industry, and ownership. When all four predictor variables are considered together, they significantly predict whether the effects of financial performnace on CSP, $\chi^2 = 21.49$, $df = 4$, $N = 308$, $p < .001$. Table 7-5 shows that only firm's size and sales growth are statistically significant while the other two variables are not. The result presents the odds ratios, which suggest that the odds of estimating correctly CSP improves by 82.9% if sale growth increases. It suggests that there are no negative association between financial performance and CSP (reject *Hd*).

Table 7- 5 Logistic Regression Predicting Effects of FP on CSP
(Pre-restructuring 1997-1999)

Variable	*B*	*S.E.*	*Wald*	*Odds ratio*	*p*
Firm's size	1.177	.479	6.026	3.244	.014
Ownership	.429	.250	2.937	1.535	.087
Industry	.001	.028	.001	1.001	.980
Sales growth	.604	.270	5.002	1.829	.025
Constant	-1.918	.540	12.608	.147	.000

7.2.1.2. The Effects of CSP on Financial Performance

This is to investigate whether higher (lower) CSP leads to higher (lower) financial performance (*H2a*), or whether higher (lower) CSP leads to lower (higher) financial performance CSP (*H2b*). I will utilize the same statistical techniques as in Section 7.2.1.1. I will compute the correlation coefficients: financial indicators (average 3-year post-restructuring in 2001-2003: ROA_{past}, ROE_{past}, ROS_{past}) versus CSP indicators.

The results of statistical analysis in Table 7-6 indicate that information disclosure has statistically positive relationships with ROA_{past} (at p =.01) and ROE (at p =.05), ethical and moral issues are significantly and positively correlated with ROA (at p =.01). Overall CSP has significant and positive relationship with ROA (at p=.01), but didn't significantly link to ROE_{past} and ROS_{past}.

The same methods in the above section were used to investigate the effects of overall CSP (controlling for firm's size, industry, ownership, and location) on subsequent financial performance (post-restructuring). The results of the analysis in Table 7-7 shows that *p*- value associated with *F* value is very small (.000), it indicates that the independent variables (CSP) can reliably predict the dependent variables (FP). CSP was found to explain about 10.8% of variance in FP (ROA). The regression equation is as follows:

$FP\ (ROA_{past}) = -2572 - 0.107{*}SIZE + 0.970{*}IND - 0.562{*}OWNSHP + 0334{*}LCTN + 0.334{*}INFODC + 0.092{*}ETHML + 0.109{*}DWNZ + 0.229{*}CSP.$

The equation shows us that every unit increase in CSP, a 0.229 increase in FP (ROA_{past}) is predicted. This provides some support for hypothesis *H2a*.

Table 7- 6 Partial Correlations between CSR and Financial Performance
(Post-restructuring 2001-2003)

	Info disclosure	*Ethic and moral*	*Downsizing*	*CSP*
ROA_{post}	0.331**	0.723**	0.108	0.227**
ROE_{post}	0.136	0.081	-0.037	0.072
ROS_{post}	0.186*	0.006	-.104	-0.011

Correlation is significant at the 0.01 level (2-tailed).
Correlation is significant at the 0.05 level (2-tailed).
Note: Control variables are Firm size, industry, ownership and location

Table 7- 7 Regression Analysis of FP against CSP
(Post-restructuring 2001-2003)

Independent variables	***Dependent Variables*** ROA_{post}	ROE_{post}	ROS_{post}
Firm size (SIZE)	-0.107	29.071**	133.717**
Industry (IND)	0.970*	-0.942	-7.799*
Ownership (OWNSHP)	-0.562	-4.321	-10.568
Location (LCTN)	0.334	0.912	5.583
F value	**1.053**	**3.153***	**3.156****
Intercept	**-4.063**	**-12.760**	**-76.326**
ΔR^2_1	**0.031**	**0.087**	**0.087**
Info disclosure (INFODC)	0.334**	0.133	0.182*
Ethical & Moral (ETHML)	0.092	0.081	0.006
Downsizing (DWNZ)	0.109	-0.036	-0.138***
CSP	**0.229****	**0.070**	**-0.010**
F value	**5.411****	**1.509**	**3.272***
Intercept	**-2.572**	**-6.876**	**25.038**
ΔR^2_2	**0.108**	**0.033**	**0.068**
Final F value	3.086*	2.234*	3.308**
Final intercept	-4.290	-10.257	47.127
Final ΔR^2	0.142	0.107	0.151

Correlation is significant at the 0.01 level (2-tailed).
Correlation is significant at the 0.05 level (2-tailed).
Note: The reference category is Higher CSP; The parameter for higher FP (ROA, ROE and ROS) is set zero because it is redundant.

The same technique of logistic regression is conducted to assess whether the four predictor variables, CSP, firm's size, industry, and ownership, significantly predicted whether or not sale growth increased. The outcome (response) variable of financial performance (sales growth) is binary: improved or non-improved. The predictor variables are CSP, firm's size, industry, and ownership When all four predictor variables are considered together, they significantly predict whether or not financial performance (sales growth) improved, $\chi^2 = 14.36$, $df = 4$, $N = 317$, $p < .001$. Table 7-8 presents the odds ratios, which suggest that a one unit increase in CSP, the odds of sale growth increased by a factor of 3.067. It suggests that there are no negative association between CSP and financial performance (reject *Hb*).

Table 7- 8 Logistic Regression Predicting Effects of CSP on Financial Performance
(Post-restructuring)

Variable	*B*	*S.E.*	*Wald*	*Odds ratio*	*p*
Firm's size	.120	.453	.070	1.127	.791
Ownership	.437	.369	1.405	1.549	.236
Industry	-.011	.035	.097	.989	.755
CSP	1.121	.370	9.154	3.067	.002
Constant	1.154	.528	4.776	3.171	.029

7.2.2. Financial and Operating Performance of Listed Firms

7.2.2.1. Changes in Financial Performance in Post-restructuring

In this section below, I present and discuss my empirical results concerning each of China's enterprise restructuring objectives set by the central government), and predicted financial changes described in Chapter 5 (testable hypotheses). I first present (in Table 7-9) and discuss my results for the complete sample of all 318 firms undergone restructurings. And then, I attempt to identify the determinants of financial performance improvements after restructuring.

Profitability Changes

My first round of empirical tests measures post-restructuring financial and operating performance. My data confirm that, following restructuring, firms experience significant decreases in profitability in the three-year post-restructuring period, compared to the average values from the 3-year pre-restructuring period. This table presents empirical results for my full sample of restructured firms. The table presents, for each empirical proxy, the number of useable observations, the mean and median values of the proxy for the three-year periods prior and subsequent to restructuring, the mean and median change in the proxy's value after versus before restructuring, and a test of significance of the mean change. I employed the Wilcoxon rank sum test (with its z-statistic) as my test for significance for the change in mean values. The final two columns detail the percentage of firms whose proxy values change as predicted, as well as a test of significance of this change. Finally, sales efficiency is computed by using inflation-adjusted sales figures divided by the number of employees each year. Deflated sales per employee is normalized to equal 1.00 in year 0 so other year figures are expressed as a fraction of base year in the year of restructuring. Net income efficiency is computed similarly.

Table 7-9 summarizes the specific results. I measured profitability with return on sales, (net income/sales), return on assets (net income/total assets), and return on equity (net income/shareholder's equity). Following restructuring, average (median) return on sales decreases from -13.54% (9.73%) to -20.87% (8.17%), mean (median) of return on assets, and return on equity as well decreases respectively from 5.70% (5.18) to 0.39% (2.41), 1.26% (10.15) to -8.64% (5.60), This decrease is significant at the 5% level. I further note that a statistically significant 39.24% of my sample firms have positive changes in return on sales, 30.19% on return on assets, and 29.25% on return on equity. Therefore, my data strongly confirms that firms become more non-profitable after restructuring.

Table 7- 9 Summary of Results from Tests of Predictions for the Full Sample of All Restructured Firms

Variables	*N*	*Mean Before*	*Mean After*	*Mean Change*	*Z-Statistic for Difference in Means (After-Before)*	*Percentage of Firms that Changed as Predicted*	*z-Statistic for Significance of Proportion Change*
PROFITABILITY							
Return on Sales	316	-13.54	-20.87	-7.33	-3.03**	39.24	-2.21*
		(9.73)	(8.17)	(-0.56)	(.000)		
Return on Assets	318	5.70	-.39	-6.09	-6.00**	30.19	-26.49*
		(5.18)	(2.41)	(-3.29)	(.000)		
Return on Equity	318	1.26	-8.64	-9.90	-5.54**	29.25	-6.63*
		(10.15)	(5.60)	(-6.14)	(.000)		
EFFICIENCY							
Sales Efficiency	202	1.63	8.98	7.36	-6.13*	71.78	-12.20*
		(0.25)	(0.55)	(0.30)	(.000)		
Net Income Efficiency	202	0.18	1.48	1.30	-2.75*	55.94	-41.63*
		(0.03)	(0.03)	(0.00)	(.006)		
EMPLOYMENT							
Employment	205	5392	4871	-520	0.78	44.23	-1.03
		(1745)	(1457)	(-288)	(.433)		
LEVERAGE							
Debt to Assets	318	47.73	56.45	8.71	-3.653**	40.06	-10.22*
		(47.57)	(49.15)	(2.42)	(.000)		

***Correlation is significant at the 0.01 level (2-tailed).*
**Correlation is significant at the 0.05 level (2-tailed).*

Efficiency Changes

To test for post-restructuring efficiency improvements, I used inflation-adjusted, sales efficiency (sales per employee: SALEFF) and net income efficiency (net income per employee: NIEFF). Deflated sales per employee is normalized to equal 1.000 in year 0 so that other year figures are expressed as a fraction of base year in the year of restructuring. I find that sales efficiency and net income efficiency increase significantly after restructuring. Average (median) sales efficiency rises from 1.63 (.25) of year-0 values in the three-year pre-restructuring period to 8.98 (0.55) after restructuring; average (median) net income efficiency rises from 0.18 (0.03) to 1.48 (0.03). This highly significant increase indicates that the post-restructuring firm uses its resources with much greater efficiency. My proportion test also reflects greater efficiency since 71.78% and 55.94% of my sample firms report higher values of sales efficiency and net income efficiency in the years after restructuring.

Employment Changes

The great fear of all governments contemplating restructuring/privatization programmes is that efficiency and profitability will be achieved only at the cost of large-scale job losses and mass redundancy. Just as advocated by the Chinese government in the Decision on Major Issues Concerning the Reform and Development of SOEs (1999) that laying off redundant workers and employees to increase enterprise efficiency. The government is concerned about employment changes for listed SOEs. Most of listed firms underwent a ownership restructuring before listing, during which the government encourage firms to downsize redundant employees to increase productivity and efficiency. I examine this by computing average employment levels for the three-year period -3 to -1 and +1 to +3, and seeing if employment falls after restructuring.

The result of my analysis is in line with the prediction. I found that employment indeed decreases by an average (median) 520 (288) after restructuring. While the Wilcoxon test is not significantly at the conventional level, the proportion test is also not significant at the 5 percent level, and the fact remains that employment levels decreases 44.23%.

Leverage Changes

While most governments do not place great priority on improving the financial soundness of the newly privatized firms, most do expect leverage ratios do drop after restructuring, for several reasons. For one thing, SOEs traditionally have extremely high debt levels, at least in part because they cannot sell equity to private investors, and thus the only forms of "equity" available to the firm are capital injections from the government and retained earnings. Given the "mushiness" of the equity accounts of both SOEs and newly privatized firms, I rely primarily on a total leverage measure, total debt to total assets (LEV). As predicted, I document a significant increase in leverage. The average (median) increases in leverage, 8.71%, and only 40.6% of the sampled firms decrease their leverage ratios after restructuring.

Having confirmed that restructured firms experience significant decreases in profitability and increase in efficiency, I next turn to my search for the causes of these performance changes.

7.2.2.2. Determinants of Financial Performance Improvements

The regression analysis is used to identify the sources of performance improvements in restructured firms. The dependent variables in the seven models are change in return on assets (ROA), change in return on equity (ROE), change in return on sales (ROS), change in sales efficiency (sales per employee), change in net income efficiency, change in leverage, and change in employment respectively. Change in each of the dependent variable is defined as the average financial and operating performance changes of 3-year post-restructuring versus 3-year pre-restructuring. The independent variables which are used in the analysis include firm's size, ownership, industry sector and location the firms are headquartered. The result of analysis is shown in Table 7-10.

Table 7- 10 Regression Results to Identify Sources of Performance Improvements

Independent Variable	*Dependent Variable*						
	ΔROA	*ΔROE*	*ΔROS*	*ΔSALEFF*	*ΔNIEFF*	*ΔLEV*	*ΔEMPL*
SIZE	32.814**	-28.273	29.559	-.019	0.993	-63.216*	650.162
	(.000)	(.337)	(.728)	(.998)	(.768)	(.000)	(.705)
OWNSHP	1.073	10.472	-1.460	5.967	1.981	-2.737	-752.821
	(.653)	(.320)	(.961)	(.998)	(.153)	(.548)	(.240)
IND	0.783	3.131	6.350	-0.336	-0.071	-1.171	-144.890
	(.099)	(.135)	(.288)	(.747)	(.776)	(.196)	(.247)
LOCATION	1.073	-8.387	44.205*	6.195*	2.120*	-2.982	760.574
	(.501)	(.232)	(.028)	(.021)	(.018)	(.326)	(.077)

N	314	313	316	204	318	200	201
Intercept	-46.515**	-6.376*	-222.459	-21.656	-9.709	88.401*	-958.833
	(.444)	(.991)	(.096)	(.196)	(.084)	(.000)	(.725)
F Value	6.604**	1.277	1.651	1.764	1.797	6.701*	1.385
	(.000)	(.279)	(.161)	(.138)	(.131)	(.000)	(.237)
Adjusted R^2	0.78	0.016	0.021	0.035	0.079	0.079	0.027

** Significant at the 0.05 level (2-tailed).*
*** Significant at the 0.01 level (2-tailed).*
**** Significant at the 0.10 level (2-tailed).*

Firm size and location are the most significant determinants of changes in post-restructuring profitability. First, a significantly positive relation between profitability and firm size was identified. This suggests that a one unit increase in firm size leads to a 32.8 increase in ROA. My finding also shows that the firms located in well-developed eastern and southern areas seem to be more profitable. The location has statistically significantly positive association with ROS.

The regression analysis shows that only the variable of location has significantly positive relationships with operating efficiency. According to Table 7-10, firms located in the developed areas show a 6.2 point greater increase in sales efficiency, and a 2.1 increase in net income efficiency than the ones located in the undeveloped areas. Firm operating in the well-developed areas are likely to be more efficient.

My model also reveals that only firm size is the main determinant of changes in leverage after restructuring. The analysis result shows that the firm's size is negatively related with leverage. It suggests that larger of the firm, less leverage it has.

The results of the analysis reveal that statistically, employment has no effects on the changes of financial performance. It implies that downsizing or lay-offs as advocated by the government in the restructuring programme does not leads to profitability and proficiency improvements.

7.3. Conclusion

This Chapter focuses on the two aspects: investigating the relationships between socially responsible restructuring and financial performance in restructuring, and examining whether there are some changes in financial and operating performance after restructuring. The results of the empirical study of relationships between CSP and financial performance are significant and have more implications for a number of reasons. First, the major theories concerning social responsibility which had been developed in the developed economy context was tested within the distinct cultural and economic environment of China. The second, a multi-dimensional measure of CSP was used, which allowed for a more comprehensive measurement to be undertaken. The results of the empirical research supported some of the postulated relationships between CSP and financial performance in restructuring. For example, the firms with more CSP may outperform the ones with less CSP in restructuring.

This study supports the studies undertaken previously (McGuire *et al* 1988, Rosen *et al* 1991, Graves and Waddock 1994, and Pava and Krausz 1996, with regard to the relationships between CSR and financial performance. The studies argue that there is a positive association between CSR and financial performance, the reason is that a firm perceived as high in social responsibility may face relative fewer labour problems or perhaps customers may be more favourably disposed to its products. Alternatively, CSR activities might improve a firm's reputation and relationship with bankers, investors and government officials. Improved relationship with them may well be translated to economic benefits. A firm's CSR behaviour seems to be a factor that influences banks and other institutional investor investment decisions. Thus a high CSR profile may improve a firm's access to sources of capital. The event study by Frooman (1997) also finds that for firms engaging in socially irresponsible and illicit behaviour, the effect on shareholder wealth is negative (wealth decrease). It also provides support for a moral position called enlightened self-interest, which prescribes that firms should act in a socially responsible manner to promote the shareholders' interests.

The results show that following restructuring, firms significantly decrease profitability, but significantly increase sales efficiency. The results are inconsistent with the growing empirical evidence that after privatization/restructuring in transition economies, firms become more profitable (Megginson, Nash, and van Randenborgh 1994; Megginson and Nash 1994; Narjess and Jean-Claude 1998; D'Souza and Megginson 1999; Wei, Oscar, Juliet, and Hassan 2003; Huang and Song 2005; Boubakri, Cosset, and Guedhami 2004). However, my study further confirmed the research done by Wei, *et al* (2003), which argues that in China, there is general trend towards decreased profitability after privatization/restructuring.

Chapter 8 Balancing Economic and Social Priorities in Restructuring China's Defence Industry

8.1. Introduction

This Chapter presents a case study which is typical model of enterprise restructuring in the defence industry. The main purpose is to illustrate how Chinese firms attempt to poise themselves on the economic and social priorities in the process of restructuring, whether the impacts of firm restructuring on the stakeholders are negative or positive, and in turn whether they would resist against any attempts for the firms to be socially responsible.

The the case study was analyzed in two parts. The first part discusses the survey on the attitudes of the managers toward CSR. The survey was designed with the structured questionnaires, conducted in 2003-2004 and 55 executives and managers with CSIGC have participated in the survey. The second analyzes the data collected from the field visits I did from 16 February to 1 March 2004.

8.1.1. Rationale for Selecting China Defence Industry as a Case Study

Since SOE reforms were initiated, more and more academic researchers have increasingly been interested in study of effects of SOE reforms on economic and social performance by case studies in individual or multiple industries (Jefferson 1990; Kalirajan 1993; Smyth, Zhai, and Hu 2001; Sit and Liu 2000; Cooke 2000; Lee 2001; Ma et al 2002; Movshuk 2004; Zhang and Zhang 2001; Godfrey 2002; Mar and Young 2001; Nolan and Wang 1998), but no study has been devoted to the defence industry, which plays a critical role in China's security and economy.

After suffering technological and industrial stagnation and contraction over the past several decades, China's defence industry has undergone an extensive restructuring since the late 1990s, the objectives were to make defence industry become much leaner, more efficient and better able to meet the high-technology needs of the People's Liberation Army (PLA) and compete in the global market. The Chinese government overhauled the defence industry's management and corporate structures in the late 1990s, and developed the comprehensive policies for reforms of defence industry to inject competition into a moribund apparatus. At the center of the organizational reforms was the separation of the military and civilian components of the Commission of Science, Technology and Industry for National Defence (COSTIND), which oversaw the management of the defence industrial complex.

A national-wide SOE restructuring was launched in China in 2002 in response to the policies that Premier Zhu Rongji made in the Report on Work of the Government in 2002 (People's Daily 2002b), he calls for speeding up the strategic restructuring and reorganizing the SOEs as well as the reform of monopoly industries. The industrial monopolies must be broken up and the functions of the government be further separated from those of enterprises by restructuring programmes. In this context, the new goals were determined in 2002 for SOE restructuring, which concentrated on restructuring of the military, non-ferrous metal, coal and some other key industries after the textile sector's readjustment in 2001. More than 160 military industrial enterprises would be closed down or bankrupted to create more large enterprises which were strongly competitive in the world market (People's Daily 2002a).

China South Industries Group Corp. (CSIGC), one of the largest defence industries can't escape the restructuring wave. According to the policy and arrangements of COSTIND, CSIGC launched the restructuring programme in the Group in 2001, with the focus on structural adjustment, debt-to-equity swap, mergers and acquisitions, bankruptcy. By 2004, there were 21 companies which were bankrupted, reduced the debt of 610 million Yuan [30]. Many companies in the Group have successfully completed the restructuring, because they can balance the economic and social priorities and take into consideration of all stakeholders that might be influenced by restructuring.

This research investigates one of the cases in defence industry to illustrate process and practices of SOE restructuring in defence industry, and to have a better understanding of issues and problems which SOEs are facing in restructuring, and the roles that the government and managers played in promoting socially responsible restructuring.

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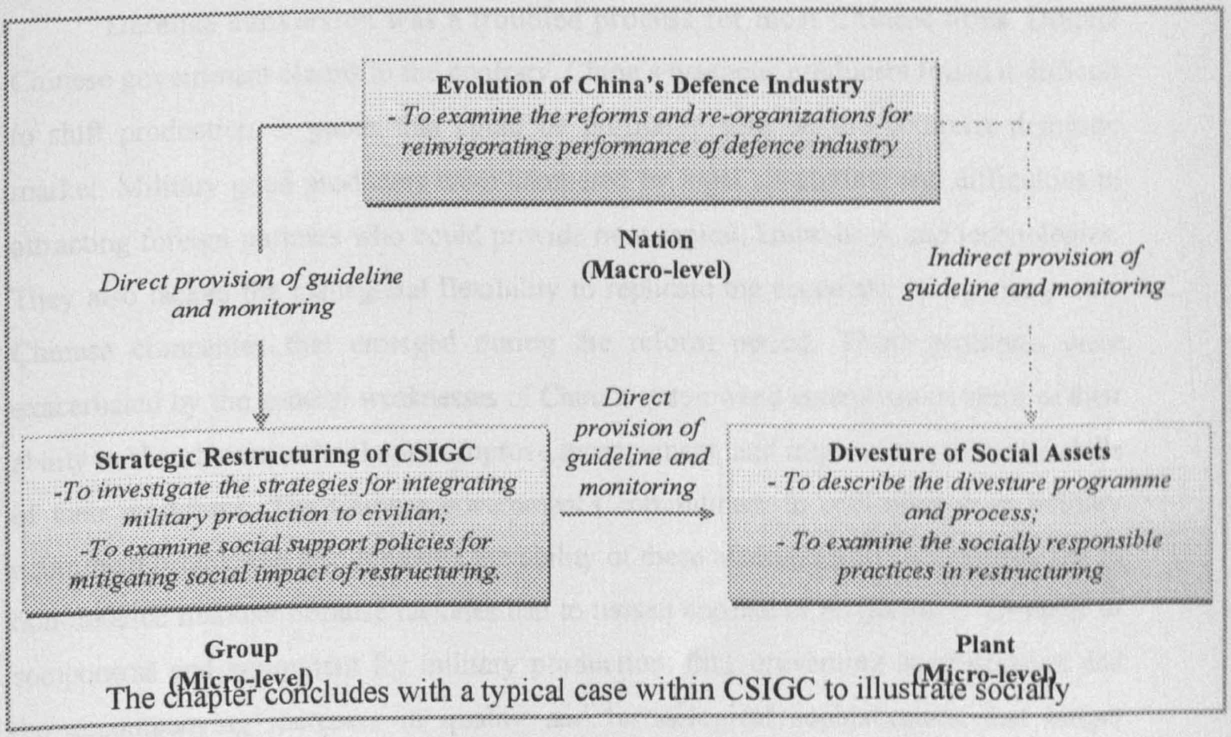
30 Annual Conference Report of China South Industry Group Corp. (2004)

8.1.2. Framework for Analysis of Case Study

This chapter begins by reviewing the evolution of China's defence industrial policies since the beginning of economic reform efforts in the late 1970s; the particular attention is given to China's most recent round of defence industry reforms initiated in the late 1990s. The chapter then examines restructuring strategies and policies launched by CSIGC in recent years. The Chapter concludes with a typical case within CSIGC to illustrate socially responsible practices adopted in restructuring.

Figure 8- 1 Framework for Analysis of the Case Study



Both of overview section and case study focus on changes in two key factors: the structure of institutions, and the nature of incentives for improved efficiency and innovation. Changes in these factors in the defence industry have begun to gradually reshape the operations and output of China's defence industries. Changes in the factors are examined at the levels of government operations (e.g. defence procurement decisions) and enterprise operations. Figure 8-1 illustrates the framework for analysis of the case study.

8.2. Reform and Restructuring of China's Defence Industry

Since the late 1970s, when Deng Xiaoping initiated reform of China's planned economy, until recently, China's defence industries led a troubled existence. Government procurement of military goods declined dramatically following the adoption of Deng's "Four Modernizations Policy" which placed the military as the last priority.[31] As a result, many defence enterprises were officially required to convert their facilities to the production of nonmilitary goods or engage in arms sales to generate income to replace dwindling government purchases of military equipment. Many firms soon became dependent on these alternate sources of income for their very survival.

Defence conversion was a troubled process for most Chinese firms. Despite Chinese government claims to the contrary, China's weapons producers found it difficult to shift production to goods that could be profitably sold on the booming domestic market. Military good producers were hampered by legal constraints and difficulties in attracting foreign partners who could provide new capital, know-how, and technologies. They also lacked the managerial flexibility to replicate the successes of the many new Chinese companies that emerged during the reform period. These problems were exacerbated by the general weaknesses of China's state-owned enterprises in terms of their ability to absorb new technologies, improve management, and improve the technical skills of their workforce. The Chinese government's commitment to self-reliance in military equipment production also hindered the ability of these enterprises to successfully sell to non-defence markets because factories had to remain capable of producing a full range of components and equipment for military production, thus preventing specialization and the accompanying increases in quality and technological sophistication that longer production runs potentially provide. As a result, many civilian goods produced by defence firms have been of low quality and relatively costly to produce and thus failed to generate profits.[32]

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[31] Frankenstein, John, "China's Defence Industries: A New Course?" in James C. Mulvenon and Richard H. Yang, eds., *The People's Liberation Army in the Information Age*, Santa Monica, Calif.: RAND Corporation, 1999.

[32] Zhang Yihao and Zhou Zongkui, "China's Science, Technology, and Industry for National Defence Face up to WTO" *Jiefangjun Bao* (internet version) 13 March 2000.

These problems are becoming more acute because the entry of many new Chinese companies in all markets has intensified domestic competition. Competition from foreign producers has also emerged now that China has entered the WTO and China's domestic markets for consumer goods have become more open to foreign manufacturers.

China's defence firms, like many of China's large SOEs, staggered along for most of the 1990s by relying on significant government subsidies. As late as 2000, China's defence industries were described as facing tremendous challenges[33]. The difficult circumstances faced by China's defence industrial enterprises were reflected by their financial circumstances. Despite the fact that supposedly over 80 percent of the aggregate output of Chinese defence enterprises were civilian goods; few firms were "profitable." According to the director of the COSTIND, China's entire defence industry ran a net loss in aggregate terms for eight consecutive years from 1993 to 2001.[34]

Aside from the financial problems of China's defence industries, the military systems have been unimpressive. The weaknesses of China's defence production capabilities are reflected by the technological backwardness of many of the systems, the long R&D and production timelines for most indigenously built weapons systems from foreign countries. The history of China's defence industry is replete with example of weapon systems with severe technologic weaknesses and limitations. In particular, manufactures appear to have difficulty in making technological leaps to qualitatively new, superior systems. Numerous sources acknowledge that China's defence industry has persistently failed to meet the needs of the military and has lagged behind the technologic development in the more market-oriented sectors of Chinese economy.[35]

8.2.1. Main Issues in Defence Industry Restructuring

The main issues of military industry restructuring and public sector reform in

[33] Ke Wen, "Advantage and Disadvantage of WTO Accession to China's Military Industry, Science and Technology – Interviewing Liu Jibin, Minister in Charge of Commission of Science, Technology, and Industry for National Defence". Chiao Ching, 16 June 2000, pp.46-48.

[34] "Defence Industry Breaks Even in 2002," *China Daily* (internet version), 9 January 2002.

[35] Chen Zengjun, "Ordnance Industry Turns into Vital New National Economic Force," *Jingji Ribao*, 20 November 1998, p. 2.

China can be grouped into macroeconomic and micro-economic categories. The macro-economic issues include the fact that the converted enterprises remain SOEs, with all the problems inherent to the SOEs, and that military industry restructuring in China was stimulated by the change in military procurement from simpler items of ordinance and military supplies to more sophisticated command and control equipment, Technology and systems with the corresponding redundancy of traditional military-industrial assets and labour which had to find other uses, lest unemployment would rise to intolerably high levels in communities over dependent on the military-industrial complex for their livelihoods (UNDP 1998).

A further factor which increases the transaction costs of conversion is the coexistence of many conversion processes: from military to civilian markets; from remote locations to locations near markets; from centrally planned system to market economy; from present business approach and management style toward a competitive market economy; and from state-owned enterprises to other forms of ownership.

Another macro-economic issue is enterprise reform, which got a boost from the 15th Congress of the Communist Party of China, as well as from the meeting of the National People's Congress of March 1998, which provide for the reorganization, association, merger, joint stock partnership, leasing, contract operation and sell-off of SOEs. This represents a major impulse to the public sector reform process in China.

The micro-economic issues include the possibility that the restructured enterprises could operate as truly commercial corporate entities, the equivalent of private firms, with clear ownership of assets and responsibility for liabilities. The setting up of joint ventures offers an opportunity to introduce such market-oriented management behaviour and to open up export markets, besides bringing in foreign investment and Technology. But, to get there the Chinese side must be prepared, in terms of public sector reform, investment promotion, strategic thinking, business planning, management training, information and business communication skills, and the regions of China hoping to host them must improve infrastructures, physical and otherwise.

Other micro-economic issues include entrepreneurship, business communication, investment financing and social overheads. The general answer to these issues is to corporatize the enterprises and institutionalize the social services so far provided by the military industries themselves, all of which are part of the process of public sector reform.

8.2.2. Key Reforms in China's Defence Industry in the late 1990s

After suffering technological and industrial stagnation and contraction over the past several decades, China's defence industry has undergone an extensive restructuring since the late 1990s to make it leaner, more efficient and better able to meet the high-technology needs of the People's Liberation Army.

The Goals of Reforms

The reforms implemented in 1998-1999 were designed to achieve a number of broad goals related to further reforming the organization and incentives of the defence industry establishment.[36] One goal was to further separate the state from enterprise operations. Although major defence firms had been converted from ministries into corporations in 1993, China's five defence companies had continued to behave very much like the ministries from which they had been created. These companies were not only involved in production but also in regulatory and policymaking issues. The tensions and conflicts of interest resulting from this model created major impediments to making defence industry firms more efficient.

A second goal was to introduce a "moderate" level of competition into the defence sector.[37] Because all the enterprises in each of the defence sectors were controlled by a single corporation, improvements in technology and management practices occurred more slowly than they might have in an environment in which multiple companies were striving to outdo each other.

Related to this, a third goal of the reforms was to provide more autonomy for individual enterprises within each defence corporation. The persistence of the

[36] Tang Hua, "Science, Technology and Industry for National Defence Increases Intensity of Innovation," op. cit.; "Chinese Premier Underlines Science, Technology for National Defence," *Peoples Daily* (English edition), 2 July 1999.

[37] Xinhua, "PRC National Ordnance Industry Conference Opens," January 7, 1998; Bie Yixun, Xu Dianlong, Xinhua Domestic Service, 7 January 1998.

ministerial system of organization meant that, while individual enterprises were nominally independent subsidiaries of the five defence companies, in practice the relationship between enterprises resembled that of organizations within a bureaucracy, with subordinate enterprises having little autonomy in their decision-making and internal management.[38] This stifled initiative and creativity.

At the same time as the reforms gave enterprises more autonomy, they also sought to make the various defence enterprises responsible for their bottom lines. Like many of China's state-owned enterprises, defence enterprises that suffered excessive losses had not been penalized. Loss-making enterprises were not allowed to go bankrupt but were simply given subsidies or bank loans to make up the difference between revenues and expenditures. This lack of financial accountability not only discouraged defence enterprises from taking steps to cut losses but also provided no incentive to innovate, because the survival of an enterprise was unrelated to the quality of its products.

While providing enterprises with more autonomy, the reforms also sought to increase the degree of horizontal and vertical integration within each of the defence sectors. Despite their hierarchical organization, the defence enterprises tended to operate in isolation, with little coordination or information sharing among them. In particular, the reforms sought to combine the functions of research and production, which traditionally had been carried out separately.[39]

Overall, the Chinese leadership's aim was to reshape the entire defence industry into three types of enterprises: "backbone enterprises" that would focus on military production, enterprises that would produce both military and civilian items, and enterprises that would focus on civilian production while using their technological capabilities to raise the overall level of China's science and technology base.[40]

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[38] Liu Zhenying, Sun Jie, "More on Zhu at Defence Group Ceremony", *Central Television Program One Network,* 1 July 1999.

[39] Bie Yixun, Xu Dianlong, "Wu Bangguo Speaks at Defence Industry Conference", 12 January 1998.

[40] "Chinese Premier Underlines Science, Technology for National Defence." *Peoples Daily* (English edition), 2 July 1999.

Organizational Reforms

Beginning in 1998, Chinese government adopted a series of policies to overhaul the organization and operation of China's defence industry. Reforms occurred both at the central government level and at the enterprise level. In general terms, the reforms aimed to centralize and standardize weapons procurement decisions at the central government level while decentralizing defence enterprise operations in order to increase incentives for efficiency and innovation.

Central Government Reforms

The government adopted two major reforms that significantly changed the weapons procurement process. First, during the 9th National People's Congress meeting, the government abolished the military-controlled Commission on Science, Technology, and Industry for National Defence (COSTIND), which had been created in 1982, and replaced it with a strictly civilian agency of the same name but under the control of the State Council and the Premier Zhu Rongji. The new State COSTIND, which was run by civilian personnel, was formed by combining the defence offices of the Ministry of Finance, the State Planning Commission, and the administrative offices of the five major defence corporations.[41] Previously, COSTIND had reported to the State Council and was staffed by both civilian and military personnel. It had been responsible for overseeing all aspects of China's defence industries, including involvement in the daily management of China's large defence firms. As a quasi-military agency, the old COSTIND had also been very heavily involved in decisions on R&D and the purchase of military equipment. It had acted as a bridge between the PLA and defence enterprises. In that role, COSTIND exerted heavy, and in some cases preponderant, influence over defence procurement decisions. COSTIND's leading role contributed to the inefficiency of the procurement process: The PLA was unable to acquire the weapons it needed, weapons were frequently delivered late, and they were

[41] *Xinhua*, 10 March 1998, "NPC Adopts Institutional Restructuring Plan," 03/10/1998; Tseng Hai-tao, "Jiang Zemin Pushes Forward Restructuring of Military Industry Developments of State Commission of Science, Technology, and Industry for National Defence and Five Major Ordnance Corporations," *Kuang Chiao Ching*, 16 July 1998, pp. 18 20.

of ten defective or of very poor quality.[42]

In terms of defence procurement and defence production, the restructured COSTIND's responsibilities, resources, and authority have been substantially circumscribed. It was no longer heavily involved in decisions on the acquisition of new military equipment or the direct management of defence industry enterprises.[43] In stark contrast to its previous incarnation, the new COSTIND controls no procurement funds and thus possesses much less influence over procurement decisions. The new COSTIND was tasked with coordinating procurement negotiations between the uniformed military and defence industrial enterprises. In that role, COSTIND was used by the military to coordinate multiple bids from defence enterprises and to ensure contract compliance by the enterprises. PLA officials have indicated that, because COSTIND was a government agency, they can trust it more than the production enterprises to ensure that contractual obligations were met. COSTIND also controlled some R&D funds for basic and applied research, although other institutions now appear to have control over most defence R&D funds. COSTIND's funds were not used to directly finance weapons production.

COSTIND was also stripped of responsibility for direct management of defence enterprise affairs. The restructured COSTIND was meant to function as the administrative and regulatory agency for China's major defence enterprises. Its responsibilities included formulating laws and regulations to govern science and technological development for national defence, organizing international exchanges, defence cooperation and arms sales to other countries, and export control administration related to military exports. Thus, COSTIND took care of the government functions of China's defence enterprises while leaving the enterprises to manage themselves, a process in which COSTIND used to be heavily involved. This change was intended to allow the enterprises to focus on business decisions regarding production, cost control,

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42 Gallagher, "China's Military Industrial Complex" Gallagher was an assistant army attaché in Beijing, and his account is based on participation in many negotiations with the Chinese in the late 1980s.

43 Tang Hua, "Science, Technology, and Industry for National Defence Increases Intensity of Innovation," *Liaowang*, 26 July 1999, pp. 16-17.

and profitability.[44]

COSTIND's role, however, continues to evolve and its responsibilities may go beyond purely administrative and regulatory affairs. According to Liu Jibin, Minister of COSTIND from 1998 to 2003, COSTIND's responsibilities and functions include "supervising the management of science and Technology for national defence" and drawing up, organizing, and coordinating the implementation of development plans for the industry. What precisely this supervision, organization, and coordination entail is unclear and suggests that governmental and corporate functions are still entangled. As Chinese analysts put it in a 2000 article on the military economy, "China is likely to maintain her centralized and unified state management by employing planning, administrative, or legal means. Moreover, China is also likely to tackle certain special issues, which might come up, by employing such means or methods as administrative intervention."[45]

The second major organizational reform, following the "civilianization" of COSTIND, was the creation in April 1998 of a new general department of the PLA known as the General Armaments Department (GAD). GAD assumed the old COSTIND's responsibilities for military procurement combined with the roles and missions of the General Equipment Bureau under the General Staff Department, as well as divisions from the General Logistics Department related to other military equipment and procurement. It was largely formed by appropriating the personnel that handled these activities from these organizations. The responsibilities of GAD include the life cycle management of the PLA's weapons systems (from R&D to retirement) and running China's Testing, evaluation, and training bases.[46] In addition, mainly through its Science and Technology Committee, GAD plays a role in broad policy debates about military modernization, defence procurement, and arms control and non-proliferation issues.

In addition to these large organizational reforms, the government also adopted policies specifically related to changing the weapons procurement process. Although

44 "Ten Military Industry Corporations are founded," *Zhongguo Hangtian* (China Aerospace), August 1999.

45 Xu Sailu, Gu Xianguang, Xu Xiangmin, *Zhongguo Junshi Kexue*, 20 June 2000, pp. 66-73.

46 Harlan Jencks, "The General Armaments Department," in James C. Mulvenon and Andrew N.D. Yang, *The People's Liberation Army as Organization: Reference Volume v1.0*, Santa Monica, CA: RAND Corporation, 2002.

most of these policies are quite new and their effect on actual production output is not yet clear, their adoption and implementation indicate the seriousness of the central government's efforts to reform the military procurement process and, ultimately, to improve production capabilities. According to Chinese officials, these policy reforms are driven by several broad goals: standardizing and centralizing the procurement system for military goods, establishing a legally based procurement system to protect both the military's and enterprises' contractual rights and responsibilities, adopting a system of market competition with open contract bidding and negotiation for defence purchases, and improving the quality and professionalism of the personnel involved in weapons procurement.[47]

Enterprise-Level Reforms

Since 1998, the Government adopted far-reaching policies to alter the relationship between the government and defence enterprises. The central government's main goals were to separate the government administrative units from enterprise operations, to make the enterprises more market-oriented by exposing them to competitive pressures, to provide harder budget constraints, to make the enterprises less reliant on state subsidies, and to lessen the classic social burdens associated with the *danwei* (work unit) system. Chinese policymakers initiated several different types of reforms to change defence enterprise operations.

The major enterprise reform, which occurred in July 1999, involved the bifurcation of each of China's five core defence companies into two defence industrial enterprise groups, or sometimes referred to group corporations. An eleventh enterprise group, for defence electronics, was established in late 2002. The Chinese government pursued two goals in undertaking this reorganization. The obvious goal was to inject competition into the defence industrial sector. China's government hopes that competition will cause defence enterprises to become more efficient, less of a financial burden on central and local governments, and more capable of independent innovation and absorbing and assimilating new technologies. The new head of COSTIND, Liu Jibin, explained in July 1999, the

[47] Xie Dajun, "The Procurement and Supervision of the Manufacture of Foreign Armaments," *Xiandai Junshi*, 15 August 1999, pp. 52 54.

core rational for this organizational change. He noted that each of the general companies is divided into two roughly equivalent groups in terms of capability. It is expected that through "proper competition each of the new companies' efficiency can be improved and management mechanisms can be transformed."

The extent to which real competition has emerged between the enterprise groups in each sector is not clear. In some sectors limited competition over defence systems, key subsystems, and parts has emerged. In others, the products of the two group companies are different enough that there is little to no direct competition between the two companies. Some Chinese writings indicate that the real goal of the recent reforms was not to promote competition in terms of products but rather in terms of "systems of organization" and "operational mechanisms."[48] That is, splitting each defence sector into two enterprise groups was apparently supposed to allow them to separately explore different approaches to organization and management so that they can learn from each other's successes and failures. This was an approach that might be adopted for increasing the efficiency of government organizations, not an effort to allow the defence enterprise groups to behave as true competitors operating in a free market. It again suggests that China's defence industries were still to some degree treated like government agencies, not as truly independent economic entities.

The other goal of the 1999 bifurcation policy was the formation of "group corporations" *(Jituan Gongsi)*. This new category of company was an element of the government's broader effort to reform ownership structures in SOEs including defence enterprises.[71] The group corporations were part of an effort to establish shareholder relationships within a company, and to further remove the government from firm operations, to distribute risk, and to increase accountability for profits and losses.[49] Many of China's major firms under the large group corporations have a long list of shareholders that own non-controlling stakes in some operations. This effort at ownership reform is one of the newest policies aimed at orienting enterprise operations toward markets.

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[48] Li Xiuwei, "Applying Technology to National Defence,"*China Space News,* 26 May 1999, p1.

[49] Peng Kai-lei, "Five Major Military Industry Corporations Formally Reorganized," *Xinhua,* 1 July 1999.

Beyond these basic structural reforms, Chinese policymakers have also implemented a variety of smaller initiatives to improve defence enterprise operations. First, enterprises are beginning to use non-government funds for military-related production projects. Enterprises manufacturing military equipment may use capital from other firms, internal monies, or investment from foreign countries to fund projects that produce weapons that are then marketed to the PLA or abroad.[50]

Second, some defence firms have created subsidiary organizations that have been listed on domestic Chinese stock exchanges in Shanghai or Shenzhen. These joint stock companies provide the controlling enterprise with an additional source of capital for reinvestment into enterprise operations. Listing on Chinese capital markets has the additional advantage of carrying with it minimal transparency requirements, an issue of concern to defence companies. To date, over 40 defence enterprises have been listed on the Shanghai and Shenzhen exchanges. Although some of these companies have been fully converted to non-military production, some of the military companies listed continue to be involved in military projects as well as production of civilian goods.[51]

A third emerging change in the defence industry is the expansion of partnerships with civilian universities and research institutes to improve educational training relevant to the development of new military technologies. The growing number of partnerships between the defence industry and national educational institutions is notable. GAD and COSTIND have begun to partner with universities in various parts of the country to improve the PLA's access to individuals with technical training. In 2002, COSTIND gave several million yuan to at least two aerospace and shipbuilding academies in Jiangsu Province that were not part of its past educational network, to develop their defence-related course offerings, to recruit students interested in defence research, and to give the staff of these academies additional training on defence technology issues.[52] These partnerships are with institutions other than the numerous universities that have traditionally been linked to China's defence industry

50 Data from Aviation Corporation Brochure in GuiZhou, 2002.

51 "Jungong Shanshi Qiye 2001 Nian Pandian," *Zhongguo Junzhuanmin* [China Defence Conversion], July 2002, p. 4.

52 See *Guangming Ribao*, 27 August 2002; *Guangming Ribao*, 6 June 2002.

establishment. This government-industry-university cooperation is most notable in the information technology (IT) field but is rapidly growing in other sectors involved in defence R&D and production.

Fourth, in recent years a limited amount of rationalization has occurred in the defence industry, although much more is needed in light of the continuing inefficiencies and redundancy still prevalent in the sector. Some shipbuilding and "ordnance" (ground systems) industrial groups, for example, have transferred ownership of large enterprises to provincial authorities in recent years. This has been a major trend in the shipbuilding industry where only 60 of China's shipyards are now controlled by the China State Shipbuilding Corp. (CSSC) and the China Shipbuilding Industry Corporation (CSIC); the remainder is run by provincial and local authorities. Another aspect of rationalization has been layoffs and downsizing. This has been occurring in fits and starts. According to one report, 61,000 ordnance industry workers were laid off in 2001, and 100 other enterprises were earmarked for bankruptcy or takeover the following year.[53]

A fifth reform initiated by COSTIND and GAD is the promotion of R&D and production cooperation among defence enterprises located in various provinces. In the past, one of the organizational deficiencies of China's defence industries was the extensive reliance on single source suppliers in production of defence platforms. This problem has been particularly acute in China's aviation industries. Such practices have contributed to the inefficiency, redundancy, and high degree of insularity in the defence industry. GAD and COSTIND are trying to address this problem by promoting greater integration and information sharing among defence enterprises and R&D institutes in various provinces. During 2000, for example, the Government Military Representative Bureau reportedly began to cooperate with its counterparts in the national defence departments of universities, colleges, and scientific research institutes of five cities in northern China. The aim of this initiative was to facilitate better information sharing across provinces about technical innovations and potential markets for new products-both military and civilian.[54] While it is far from clear how successful this effort has been

[53] "Defence Commission Minister Sets Targets for 2002," *Zhongguo Xinwen She*, 7 January 2002.

[54] Jiang Huai and Fu Cheng, "Beijing Military Representatives Bureau Cooperates with Five

in overcoming deeply ingrained localism in defence production, the adoption of this plan to boost cross-province defence industry cooperation indicates that the government recognizes these problems and is making efforts to overcome them.

Last, the reform of the military representative office (MRO) system became a recent priority for senior leaders in the GAD system. For years, the PLA used a system of military representative offices at the city, enterprise and factory level to ensure quality control and contract compliance of defence projects at factories and research institutes.[55] In light of the high degree of diversification of defence factories into civilian production since the 1980s, most MROs were based in civilian factories and institutes involved in defence work. The MRO system had been troubled and ineffective for many years. MROs were understaffed and military personnel were reportedly overworked. Many MRO personnel lacked the technical expertise to effectively oversee contract compliance and ensure quality, a problem that in some cases is exacerbated by high staff turnover. Overall, staffers have done a poor job of monitoring and evaluating ongoing equipment production. The objectivity and reliability of many MROs were problematic because representatives who reside at factories for a long time tend to shift their loyalties from the military to protecting the interests of local factories and townships.[56]

These weaknesses in the MRO system were significant because many manufacturers show a disregard for ensuring the quality and reliability of their products and often miss production deadlines. Factories often gave a higher priority to the production of civilian products than military ones due to their higher profit margins. Consequently, in recent years the government has initiated a major effort to overhaul the MRO system to improve contract compliance and quality control monitoring. Both the

Provinces and Cities in North China in Building Regional Cooperation with Various Layers and Professions," *Jiefangjun Bao,* 18 September 2000, p. 8.

[55] Chinese media reports have identified Military Representative Offices in Beijing, Wuhan, Shenyang, Changsha, Shanghai, and Wuhan. According to one report there were seven military representatives in a factory. See *Jiefangjun Bao,* 14 November 2001.

[56] Wu Ruihu, "Navy Military Representative Hard at Work in Supervising Armament Development," *Jiefangjun Bao,* 10 April 2002.

State Council and COSTIND issued a series of new policies on improving the quality of military production. These new regulations included an entire system for improving monitoring and boosting education of military representatives. The effectiveness of these measures, however, was far from clear.[57]

8.2.3. Constraints on China's Defence Industry Reform

The government's ability to reform the management of defence procurement and to change the incentive structures among defence enterprises had a direct effect on the future production capabilities of China's defence industrial complex. Despite the many reforms in institutions and incentives in the defence industries since 1998, it was not yet clear how efficacious these reforms have been. The Government had a long and highly blemished history of adopting weak reforms and failing to implement more radical policy changes. It was not clear how quickly and effectively the post-1998 measures could overcome the inertia and extensive problems that have plagued China's defence industrial establishment for the past several decades. Many of these problems were deeply entrenched in the central government bureaucracy, provincial-level agencies, and enterprise-level business operations.

The government's success at fully implementing defence industrial reforms was broadly influenced by several tensions or "contradictions" that persisted at both the central government level and the enterprise level. These tensions constituted the broad, systemic constraints on China's newest, post-1998 effort to reform the defence industry system. The major tensions included the following:

Reform Imperatives versus Social Stability. Efforts to rationalize and downsize China's large, bloated, and inefficient defence enterprises raised concerns about social stability, especially increasing unemployment, inability to fulfil pension commitments, and cutting off funding for enterprise-run social welfare programs. The 1998 reforms eliminated a number of the social welfare obligations of many state-owned defence enterprises, such as housing and health care. However, the managers of some defence enterprises have been reluctant to implement these reforms for fear of the impact on

[57] Zhang Yi, "The State Adopts Effective Measures for Improving Quality of National Defence-related Products," *Xinhua*, 23 March 2000.

social stability. Riots and social unrest related to rationalization at defence factories have already occurred in China. Such concerns likely limited the pace and scale of defence enterprise reform.

GAD Versus State COSTIND. The civilianization of COSTIND and the creation of GAD injected new Tensions into the 1998 round of defence industry reforms. GAD gained influence over central government procurement-related decisions at the expense of COSTIND. These new agencies often competed for influence in the defence procurement process. This tension contributed to delays and inefficient decision-making on specific military projects. The competition between these agencies will continue to complicate the government's ability to streamline the procurement process and to reform defence enterprise operations.

Localism versus 揊ree Market? Practices. Historically China's defence industrial enterprises were highly vertically integrated and relied on single-source suppliers. These patterns have been exacerbated by long-standing political ties within regions and provinces that influence business relations among firms in the same localities. As a consequence, many defence enterprises were reluctant to seek cooperation with firms in other regions, even though they may offer higher-quality and lower-cost products. This constituted a significant barrier to improving the quality of weapon systems and reducing the costs of defence production.

8.3. Strategic Restructuring in China South Industries Group Corp.

8.3.1. Background

China South Industries Group Corp. (CISGC) is one of large State-owned enterprises in defence industry, established in July 1999 with the approval of the State Council of the People's Republic of China and split-off from the former China North Industries Group (NORINCO(G). Under CSIGC, there are 51 large-and medium-sized industrial enterprises and 4 research institutes and 3 R&D centres. With registered capital of 12 billion yuan (RMB) and about 135,000 employees, CSIGC has established marketing institutions in over 30 countries and regions around the world, and their products have been exported to over 100 countries and regions.

Since it was converted to key civilian industries, while consolidating its role in developing and manufacturing military product, and improving R&D in defence industry, CSIGC succeeded in adjusting production structure, enhancing the civilian products as its core businesses such as automobile and motorcycle manufacturing, optical and electronic industries. Chang'an Automobile Corp. Ltd., China Jialing Group Corp. Ltd., China North Industries Corp.(NORINCO), and Jianshe Industries(Group) Co. Ltd. are some of its wholly-owned or holding companies.

As I described in Section 3, beginning in spring 1998, during the 9th Meeting of the National People's Congress, China's leadership initiated a new series of policies to reform the operation of the defence procurement system at the government level and to restructure the defence industries at the enterprise level. These policies have set the stage for institutional changes in the management of China's defence industry that outstrip past efforts in both scope and depth. These reforms indicate an acknowledgement of the depth of the problems of China's defence industrial system. They include policies intended to genuinely transform the structure and operation of that system by seeking to streamline and reduce corruption and inefficiency in the procurement process and forcing a degree of rationalization and accountability at the enterprise level.

The defence industry's corporate structure also has undergone major restructuring. The eleven leading state-owned defence industrial corporations that oversee the corporate management of the defence industry have undergone streamlining and management reform to inject greater efficiency, cut waste and adopt market discipline in their operations.

In this context, after split from NORINCO, CSIGC has launched radical ownership restructuring in the whole group with a view to transform the group to become a competitive conglomerate in the global market. Before analyzing the restructuring strategies in CSIGC, I want to present the result of management survey about perceptions of executives of CSIGC toward CSR.

8.3.2. Perceptions of Managers toward CSR

The interview was conducted with the structured questionnaires to determine the profile of managers' attitudes on CSR. The survey contains five components: the attitudes toward CSR in general; managers' orientation to the power and impact of stakeholder groups; determinants of socially responsible actions in the context of China's economic development; determinants of socially responsible performance in restructuring, and the areas of CSR activities the firms have involved in recent years. The statements in the structured questionnaires were given on a five-point interval scale which ranges from (5) strongly degree to (1) strongly disagree.

Corporate Social Responsibility

This part of questionnaire contains eleven statements addressing the attitudes for and against CSR. It intends to investigate the perceptions of managers about various perspectives of CSR in terms of relationship between CSR and profitability, CSR and constituencies such as governments, banks and investor, CSR and firm's reputation, CSR and government regulations, CSR and business environment, CSR and public relations.

Table 8-1 shows the distribution of sampled managers' attitudes toward CSR. The managers were requested to respond to the three statements in the questionnaire: Whether the exercise of CSR is inconsistent with the profitability; whether business should participate more actively in social responsibility in prosperous economic times than in recession, and whether high social responsibility can put a firm at a economic disadvantage compared to less socially responsible one.

In response to first statement, the managers grouped into a large majority: 61.8% agreed that the socially responsible actions do not conflict with pursuit of profits, while spending money for social programmes will actually result in more profit for the business. However, there is a small proportion (27.2%) agreed that businesses' function is to maximize profits, and firm should concentrate on business. This argument is in line with the classical economic doctrine of profit maximization, which argues that economic values are the sole criteria used to measure success. The manager is the agent of the stockholders, and all of his decisions are controlled by his desire to maximize profits for them. Only 10.9% held the neutral stance. Responding to the second argument, a large proportion (80%) agreed that businesses should actively participate in socially responsible activities; not only in prosperous economic times, but in recession. 9.1% believed that the social programmes shall be suspended or stopped in recession.

This implies that being a socially responsible firm should assume the social responsibility at any time. In response to the third statement, about half of interviewed managers disagreed that high CSR could put a firm at an economic disadvantage. Only 20% thought it could happen.

Table 8 - 1 Attitudes of Managers toward CSR

Statements	*Total*	*Mean*	*Strongly agree*	*Agree*	*Neutral*	*Disagree*	*Strongly disagree*
1.Engagement of a firm in socially responsible actions does not conflict with pursuit of profit	55	3.64	32.7	29.1	10.9	23.6	3.6
2.Business will participate more actively in social responsibility in prosperous economic times than in recession	55	4.11	41.8	38.2	10.9	7.3	1.8
3.A business that wishes to capture a favourable public image will have to show that it is socially responsible	55	4.35	50.9	40.0	1.8	0.0	0.0
4.There is no difference between involvement of a firm in socially responsible activities and public relations positioning	55	2.65	7.3	12.7	23.6	50.9	5.5
5.Business already has too much social power and should not engage in social activities that might give it more	55	3.40	25.5	23.6	20.0	27.3	3.6
6.If business is more socially responsible, it will avoid additional regulations of the economic system by government, and reduce restricts in firm's operation	55	2.96	7.3	25.5	25.5	40.0	1.8
7.Involvement by business in improving its local community's quality life will also improve long run profitability	55	4.00	29.1	50.9	12.7	5.5	1.8
8.A firm perceived as high in social responsibility can face relatively low level of industrial conflicts	55	3.75	23.3	45.5	14.5	14.5	1.8
9.High social responsibility can put a firm at an economic disadvantage compared to less socially responsible one	55	2.51	1.8	18.2	20.0	49.1	10.9
10.Socially responsible activities can improve a firm's standing with bankers, and access sources of capital	55	3.13	1.8	36.4	34.5	27.3	0.0
11.Socially responsible activities can improve a firm's standing with investors, and reduce financial risk	55	3.18	3.6	34.5	40.0	20.0	1.8

It is assumed by many people that engagement in CSR is just like to launch public relation campaign in favour of firm's business. The result reveals that over half (56.4%) of respondents didn't agreed that CSR is a kind of public relations positioning (PRP), they have difference in nature. Less than half (43.6%) agreed or held neutral stance in the argument. Obviously, there was a slight difference between the two groups; it implies that most of Chinese managers haven't better understanding of the difference between CSR and PRP.

Corporate image/reputation is a function of organizational signal which determine the perceptions of various stakeholders regarding the actions of an organization. Because of its relations to actions of an organization, image has been studied as an indicator of the social performance of the organization. Many companies know that being a socially responsible firm can get or keep a positive image, increase sales, being a socially irresponsible firm can be punished by the market, lose customers, and may even go out of business. The result of the survey shows that a large proportion (90.9%) of respondents agreed that a business that wishes to capture a favourable public image will have to show that it is socially responsible, only a very small proportion (1.8%) took the neutral stance. It sends a signal that a good corporate citizen requests its business partner to show it is social responsible, and a positive image. Moussavi and Evans (1986) argues that social responsible activities may also improve a firm's standing with such important constituencies as bankers, investors, and government officials, because improved relationships with these constituencies may bring economic benefits. However, my survey shows that less than half of interviewed managers didn't agree that if business is more socially responsible, it will avoid additional regulations of the economic system by government, it can improve a firm's standing with bankers and investors. This is in connection with the question that if business already has too much social power and should not engage in social activities that might give it more (49.1% agree, and 30.9 disagree); especially, it is true in the context of Chinese SOEs, where SOEs assume very heavy social services for their employees and as well as the communities they operate. Financial and administrative burdens associated with social services raise costs and prevent SOEs from being competitive, and it is considered as an additional barrier for external investors who might refrain from investments in enterprises with large social liabilities.

In conclusion, judging from the means of eleven statements, which are composed of seven positive statements (means of 3.57), and four negative (means of 3.17), the results of the means imply that the managers of CSIGC are moderately in favour of CSR.

Managers? Orientation toward Impact of Stakeholders

To measure the orientation to seven stakeholder groups, the managers were asked to answer the following two questions which are: (a) to what extent, do stakeholder groups have impact on your firm's public image/reputation; (b) what relationship your firm has established with the stakeholder groups. Each item used a 5-point Likert-type response scale indicating the relative degree of impact, and relationship. The table 2 reveals the result of interview analysis.

The descriptive statistics are given in Table 5. In terms of the impact of stakeholder groups on firm's reputation, the means of the stakeholder orientation indexes show that the managers in CSIGC tend to rank customer, employees and government as the highest (the means of the three stakeholder groups are respectively 4.45, 4.31 and 4.36), closely followed by the general public, shareholders and business partners (4.13, 4.04 and 4.04). The other stakeholders' impact ranked considerably lower among the managers, with communities ranked the lowest (3.72). Over 90 percent of respondents agreed that employees and customers can exert much more influence on a firm's reputation or image, and more than 80 percent perceived that governments and business partners play a important role in influencing a firm's business reputation.

Table 8 - 2 Descriptive Statistics for Impact of Stakeholders on Firm's Reputation and Firm's Relationship with Stakeholders

Stakeholder Groups	No.	Extent of Impact on Firm's Reputation*			Extent of Relationship with Firm**		
		Mean	Percentage of impact	Rank by mean	Mean	Percentage of good relations	Rank by mean
Shareholders	55	4,04	78.2	5	3.95	81.8	4
Customers	55	4.45	90.9	2	4.04	87.4	2
Employees	55	4.31	92.7	1	4.05	83.6	1
Business partners	55	4.04	83.6	4	3.98	80.0	3
The general public	55	4.13	76.4	6	3.76	69.1	6
Local communities	55	3.84	76.4	7	3.60	60.0	7
Governments	55	4.36	85.4	3	3.91	76.4	5

Reputation Scale: 1= unsure, 5 = great impact. ** Relationship Scale: 1= worse, 5= the best.

Table 8-2 also reveals the views of managers about their firms' relationship with stakeholder groups. It shows that employees and customers again were ranked as the highest (4.05 and 4.04), and closely followed by business partners, shareholders and governments (3.98, 3.95 and 3.91), and once again, the general public and local communities were ranked as the lowest (3.76 and 3.60). Over 80 percent of managers reported that their firms have had a good relationship with employees, customers, shareholders, business partners. It seems that the extent of firm's relationship with stakeholder groups is associated with impact on firm's reputation.

Determinants of CSR in the China's Context

As shown in Table 8-2, and as well confirmed by some studies, one of the criteria for enterprise success, and not least important, is the quality of the enduring relationships which a firm develops and maintains with stakeholders such as employees, customers, governments, business partners – all essential for a flexible and cooperative response to continual change and turbulence. This question in the survey is to determine what enterprise behaviour is more socially responsible in the context of the current economic development in China.

Table 8 - 3 Survey Result of CSR Determinants in the China's Context

	Total	*Strongly agree*	*Agree*	*Neutral*	*Disagree*	*Strongly disagree*
1. Complying with state law and being a good tax payer (Governments)	55	69.1	27.3	3.6	0.0	0.0
2. Provision of quality products and services for customers (Customers)	55	69.1	21.8	9.1	0.0	0.0
3. Improving environmental quality and pollution control (Environment)	55	61.8	34.5	3.6	0.0	0.0
4. Provision of a healthy and safe working environment (Employees)	55	61.8	32.7	5.5	0.0	0.0
5. Creating value for company shareholders (Shareholders)	55	61.8	27.3	9.1	0.0	0.0
6. Doing business with its partners with integrity (Business partners)	55	45.5	49.1	5.5	0.0	0.0
7. Actively participating in social benefit activities (Communities)	55	23.6	54.5	20.0	1.0	0.0

We found out in Table 8-3 that the degree of managers attached to the specific stakeholder-oriented activity. A 5-point Likert-type response scale was also used ranging from 5 (strongly agree) to 1 (strongly disagree). The result indicates that 69.1 percent strongly agreed that a firm should comply with state law in doing business, and being a good tax payer (governments), and produce quality and services for customers.

61.8 % strongly agreed that a firm should pay attention to environment protection and pollution control, care about their employees by improving their working conditions, and also it's important to generate return to shareholders. Less than half of respondents agreed that attention of a firm should be placed on doing business with partners in an ethical manner and on involving social benefit activities. As a result of the interview, the socially responsible enterprise in the China's context could be defined as: does business within the framework of legal requirements (*legal responsibility*); protects environment from damage and pollution *(environment responsibility*); considers employees as its most important assets, provides meaningful work, fair wages and benefits, and provides an enabling working environment; and contributes to the prosperity and social cohesion of the communities in which it operates (*social responsibility*); rewards shareholders with a reasonable return over time and is customer focused *(economic responsibility*); and finally, applies the golden rule ("do unto others as you would have them do unto you") to its business partners (*ethical responsibility).*

Determinants of Socially Responsible Performance in Restructuring

Socially responsible restructuring means adopting business policies and practices to avoid the need for layoffs, embracing training programs that redeploy "redundant" employees to different jobs within the company, and employing other innovative instruments to avoid or reduce the need to downsize; adopting practices that eliminate or reduce potential problems when downsizing must occur, including open communications, fair severance benefits, transition services for those being downsized, and adequate attention to "survivors" - the employees left behind to work inside a downsized company. In the context of China's SOEs, the managers may perceive the socially responsible performance in restructuring in a different way. In my survey, the managers of CSIGC were asked to determine what enterprise behaviours or strategies are more socially responsible in restructuring. Nine statements were given in terms of social policies and strategies in the process of enterprise restructuring.

The statistical analysis in Table 8-4 reveals that in the process of restructuring, in the pre-restructuring, the managers attached the most importance to open communications with stakeholders which are affected by the restructuring, in particular, employees, local communities (mean 4.36, and 94.5% agree), and followed by seeking inputs from stakeholders, and early announcement. During the restructuring period, the means of specific practices shows that provision of internal or external outplacement service (4.38) was ranked as the most importance of determinant of socially responsible performance, and followed by support of self-employment through start-up their business (4.27), and provision of severance payment for voluntary early retirement (4.18). In the post-restructuring, 85.4% of respondents agreed that it's essential that salary and benefits for a period time should continue to be offered so that terminated employees can have reasonable time to find new jobs (4.15), and in the meantime, the redundant and laid-off employees and workers can be transferred to other units (4.07).

Overall, the means of all nine measures related to determinants of the socially responsible performance in restructuring are more than 4.0; it indicates that all the practices are relatively important to socially responsible restructuring. It also implies that consultation process involving employees, trade unions, representatives of local government should be conducted before restructuring starts. It provides the parties involved, as early as possible, an opportunity for consultation on measures to be taken to avert or to minimize the impact of restructuring on stakeholders, particularly employees. Early communication and consultation with employees and other stakeholders who might be affected by restructuring is important to ensure fairness and transparency of the restructuring process. Voluntary redundancy arrangements and benefits can reduce workers' resistance to restructuring and facilitate transition. After restructuring, the temporary income support programmes (e.g. unemployment benefits, unemployment assistance, social assistance, early retirement schemes) should be offered to the displaced workers and employees, so that they can maintain the basic living standards and have time to do job research.

Table 8 - 4 Perceptions of Socially Responsible Performance in Restructuring

	Total	Mean	Strongly Agree	Agree	Rank by mean
1. Prior to restructuring					
Open communications with employees about the restructuring event	55	4.45	50.9	43.6	1
Seeking inputs from employees, trade unions and local communities	55	4.35	43.6	49.1	2
Announcements of restructuring decision in very early stage	55	4.33	56.4	29.1	3

2. During restructuring					
Providing internal or external outplacement service such as training for employability, job counselling, financial planning and information on government benefits	55	4.38	47.3	43.6	1
Encouraging and supporting employees to start up their own businesses	55	4.27	40.0	49.1	2
Providing severance benefit package for voluntary early retirement	55	4.18	30.9	56.4	3
Assisting employees in obtaining government benefit and job training support, job search allowance	55	4.15	27.3	61.8	4
3. post-restructuring					
Continuing to offer salary and benefits for a period time in order to allow reasonable time for job search	55	4.15	30.9	54.5	1
Organizing the transfer of redundant and laid-off employees to other units, giving them priority for job vacancies	55	4.07	29.1	50.9	2

Involvement in CSR Activities

We notice that the managers in CSIGC attached great importance to CSR, this survey also intends to figure out what socially responsible activities the firms of CSIGC have involved over the past 3 years.

The results found in Table 8-5 that over the past 3 years, all of the firms have involved in the social welfare for employees, and improvement of environment and pollution control. More than 80 percent involved in organization and participation of social benefit activities, employees voluntarism, contribution to state tax and contribution to assist the vulnerable and handicapped group. Few of firms were interested in financial supports for the cultural and educational programs (60%), donation to the social welfare organizations (41.8%).

The results imply that the managers allocated less importance to corporate philanthropic responsibility than other responsibilities. It seems that the managers don't perceive the philanthropic activities as a proxy of CSR. This is because CSR embodies four kinds of responsibility: economic, legal, ethical, and philanthropic. All these responsibilities have always existed to some extent, but it has been in recent years that ethical and philanthropic functions have taken a significant place (Carroll 1979, 1991).

Table 8 - 5 Areas of CSR Involved by Firms in the Past Three Years

	NO.	%
9. Organizing or participating in public welfare activities	55	83.6
10. Encouraging employees' voluntary welfare programmes	55	89.1
11. Improving employee welfare (facilities and benefits)	55	100.0
12. Active contribution of tax to government	55	98.2
13. Improving pollution control/environment impact	55	100.0
14. Contribution to vulnerable group	55	80.0
15. Donation to charitable and public welfare organizations	55	41.8
16. Contribution to cultural and literary programmes	55	60.0

Conclusion

The results of the management survey tells us that the managers in CSIGC have been getting more aware of the concept of CSR, and agree that it's important for a firm to engage in socially responsible actions, a better society can produce a better environment for the business to grow; and a socially responsible firm can capture a favourable public image to attract more investors and customers. The survey shows that managers in CSIGC regard employees, customers and government as their primary stakeholders, and pay more attention to establish good relationships with them. Most of respondents were willing to be a good tax payer, provide quality products and good services for customers, and a healthy and safe condition for employees to work. However, they ignore the importance of another stakeholder: local community.

The survey also attempts to investigate in the context of Chinese economic development, how the managers interpret social responsibility and behaviour in restructuring. The result reveals that being a socially responsible firm, it does business within the framework of legal requirements; protects environment from damage and pollution; considers employees as its most important assets, provides meaningful work, fair wages and benefits, and provides an enabling working environment; and contributes to the prosperity and social cohesion of the communities in which it operates; rewards shareholders with a reasonable return over time. When the downsizing is inevitable to be implemented in the restructuring, the necessary support measures and programmes should be taken during the three stages of restructuring; much attention should be paid to the pre- and post-restructuring. For example, prior to implementation of restructuring, consultation process involving employees, trade unions, representatives of local government should be conducted. The parties should be involved as early as possible.

Early communication and consultation with employees and other stakeholders concerned is important to ensure fairness and transparency of the restructuring process. Voluntary redundancy arrangements and benefits can reduce workers' resistance to restructuring and facilitate transition. After restructuring, the temporary income support programmes (e.g. unemployment benefits, unemployment assistance, social assistance, early retirement schemes) should be offered to the displaced workers and employees, so that they can maintain the basic living standards and have time to do job research.

8.3.3. Restructuring Strategy and Policy in CSIGC

Since the beginning of the 21 century, SOE restructuring in China has concentrated on restructuring of the military, non-ferrous metal, coal and some other key industries after the textile sector's readjustment in 2001. More than 160 military industrial enterprises would be closed down or bankrupted to create more large companies and enterprises which were strongly competitive in the world market (People's Daily 2002a). CSIGC is one of the largest defence industries in China, therefore, in line with the strategies and principles laid by the central authorities in 1998, which require all large and medium-sized SOEs to undertake restructuring through M&As, bankruptcy, lay-off and downsizing to streamline business and increase productivity and profitability, and the arrangements made by Commissions of Science, Technology and Industry for National Defence (COSTIND), by the end of 1998, the employees and workers in the defence industry must be downsized from 2.07 million to 1.5 million. The requirements of labour force in the defence industry should be determined by the principle, which is that the production capability should be determined by the sale, and the size of workers/employees required by the company should be decided by production capability. COSTIND requires all enterprises in defence industry take aggressive measures to downsize and displace the workers through different restructuring approaches to improve competitiveness and productivity.

In response to the strategies and policies, CSIGC launched group-wide restructuring since 2001, with the focus on divestiture of labour force through spin-off, structural adjustment, debt-to-equity swap, mergers and acquisitions, bankruptcy. Over the past few years, the CSIGC has strengthened structural adjustments and reforms, restructured some enterprises, realized the debt-to-equity swap of nine enterprises and bankrupted some insolvent enterprises. In light of the needs of debt-to-equity swap and adjustment of production capability, efforts have also been made to establish corporate operational mechanisms and to introduce standardized management. These measures accelerated the optimization of capital structure, promoted asset utilization; raised management levels and revitalized loss-incurring enterprises

In 2004, a new strategy, called "622 Development Strategy", was approved by top management. The goals defined in the strategy are to double the profitability and productivity, and make CSIGC become the Fortune 500 in two different phrases within 6 years. The first stage (2004-2006) will centre on: (a) restructuring to streamline the business through divesture of labour, getting rid of debts, and as well removing social burdens that firms shoulder; (b) developing system of corporate governance to legalize and modernize the firms; promoting diversification of ownership of SOEs. The second (2007-2009) will concentrate on developing CSIGC into the large global corporation which can compete in the global market through developing core competency such as civilian products and services.

Re-adjustment of Production Capacity

The vision of CSIGC is to take the special military products as foundation, and civilian products for prosperity; and make it become a competitive conglomerate at the international level. The current goal of CSIGC is to maintain 10 percent annual growth, and to increase the industrial added-value to over 4.7 billion Yuan. The strategy is to integrate the military production into civilian production, determine automobile, motorcycle, vehicle spares parts, and optics and electronics as the four core businesses, to maintain the position of its military equipment manufacturing, and particularly, to increase the competitiveness in the civilian product market.

In the automotive field, CSIGC decided to make automobiles the principal driving force behind the development of automobile spare parts. Special emphases were placed in development of two joint-venture companies—"Chang'An-Ford" and "Chang'An-Suzuki", in enhancing the competitive advantages in minivans and mini-trucks. Chongqing in Southwest China was determined as the automobile manufacturing base, within which, the Chang'An Industry Development Garden will be established to realize the mission of 120,000 capacity of automobile production. In addition, other two manufacturing companies will be set up in NanJing and Hebei to gradually develop the reasonable regional structure of automobile manufacturing in the country, to facilitate the trans-regional development of their automobile, and to capture more shares in the domestic automobile market.

The strategy for motorcycle development is to accomplish the transfer of large undertakings by using as much resources as possible; to speed up internal restructuring through spin-off and bankruptcy, in the meantime, to encourage foreign-funded and private companies to participate in the enterprise restructuring. The engineering and modernization of production must be promoted. It is planned to reduce the cost of supply of raw materials and other accessory equipment, production and circulation, shorten the cycle of production, improve work organization system, and increase the investment in R&D to enhance the core competencies in the motorcycle design and production.

In 2003, CSIGC also launched the restructuring plan for photo-electronic products, and made crucial progress in some programs, which laid the foundation for the new growth point. The focus will be concentrated on the spherical lens, model line of optical processing and new photo-electronic materials in the future.

As far as vehicle spare parts are concerned, the efforts have been made to strengthen the cooperation with business partners, upgrade the production, and R&D capabilities. The internal restructuring has been undertaken to accelerate the development of vehicle parts manufacturing.

Improving the Technological Capacities

The overall strategy for improving the technological capabilities of China's defence industries has three main elements. The first is selective modernization. China's government realizes that given the size of China's economy and the overall technological level of the country, it would be too costly to attempt to acquire the capability to produce advanced weapon systems across the board. China's government is focusing on making breakthroughs in certain key areas. The second element of the strategy is civil-military integration. Despite the difficulties associated with defence conversion described above, China's leaders remain convinced that the integration of civilian and military production is the key to developing an advanced military. Although in the early 1980s the primary hope was that China's defence manufacturers would be able to use their technological capabilities to generate profits on civilian markets, today the principal hope seems to be that, through participation in commercial production, China's defence manufacturers will acquire dual-use technological capabilities that can be used in the production of weapon systems. China's government also continues to count on civilian production by China's defence manufacturers to maintain their financial solvency, reducing the amount of funding the government needs to provide simply to keep these enterprises afloat.[58]

The third element of the Government's strategy is acquiring advanced foreign technology. With the aim of not undercutting the long-term goal of self-reliance in defence production, China sees importing foreign technology as essential to enabling it to achieve independence in defence production. Given the backwardness of China's defence industries relative to the advanced nations of the world, Chinese leaders believe that the best way to rapidly achieve this goal is to import both the Technology for producing state-of-the-art military equipment and the equipment itself until Chinese manufacturers can produce more technologically advanced products.

CSIGC intends to take advantage of the high technology in the defence industry, and human resource, and financial resources on making breakthroughs in key fields. Mini-autos, motorcycles, parts and components for vehicles, and photo-electronics have constituted the backbone of the group's civilian products. The sales volume of the automobiles produced was 232,000 last year, an increase of 16.3 percent over the previous year, and occupied fourth position in the domestic automobile industry. Both the output value and sales volume of Chang'An Automobile Company Ltd. exceeded 10 billion Yuan. Motorcycle sales were 1.471 million Yuan, of which 'Jialing' motorcycles' accounted for 803,000 Yuan, up 7.9 percent over the previous year. The sales volume of automobile and motorcycle parts and components was 3.88 billion Yuan, an increase of 4.2 percent over 2000.

In terms of CSIGC's strategy for high technology and innovation, CSIGC has put forward the new objectives for the development of military and civilian productions

[58] Liu Jibin, "Implement the Guideline of Military-Civilian Integration, Rejuvenate the National Defence Science and Technology Industry," *Renmin Ribao*, 2 February 1999, p12.

over the next few years: firstly, an open R&D system of military production should be set up by effective integration of internal resources, and by collaboration with external resources. The R&D system is featured by scientific structure, and core competencies. Secondly, the investment should be increased in development of high technology and innovation. Special attention should be focused on applying information technology in military production, and on developing independently new models of vehicles and optical-electronic products, by drawing on the advanced experience and practices of other countries.

Restructuring Ownership

During the 1990s, more and more corporations in China enhanced firm performance through restructuring their capital or ownership and assets. They have improved their multiples (price/earnings ratios) by improving their operating performance through incentives for managers and increasing strategic flexibility to acquire and form alliances. They have also appealed to new kinds of investors and have provided greater transparency and more relevant information about the company. There were different techniques of ownership restructuring, such as spin-off, bankruptcy, equity carve-out, management buyouts, employment ownership, and the break-up of parts of a corporation.

The spin-off and bankruptcy have been frequently used in CSIGC to get rid of firm debts and improve its firm performance. The spin-offs were one solution for conglomerates concerned about their ability to remain competitive in some of their business. In terms of bankruptcy, the interests of all stakeholders were compromised when companies were forced into bankruptcy. Laws exist in most of developed countries to protect shareholders from creditors who may be ready to close down a company in order to claim repayment of debts without regard to the true stakeholders' concern about the company as an ongoing enterprise. In other countries, courts decide when a company can go into bankruptcy and how it will be managed. China began to carry out the merger and bankruptcy policy in 1996, mainly in coal, nonferrous metal, sugar, textile, iron and steel, and as well defence industries, in a bid to streamline and restructure SOEs. As a result, more than 6,400 large and medium-sized SOEs were merged or downsized during 1996 to 1998, and 1,843 enterprises went bankrupt or closed down in 1999, writing off non-performing loans of 29.1 billion Yuan.[59]

One of the strategies and policies of ownership restructuring in CSIGC focused on the "10510 Scheme", which requires that by 2005, 10 companies must go bankruptcy; 5 others must start the bankruptcy process; and another 10 firms are expected to get approved by the central Government. Another one was to spin off subsidiary or non-core business from the core business in the large and medium-sized enterprises; then the spun-off subsidiary firm must be restructured to become the economic entity and create more job opportunities for re-deployment of laid-off and unemployed workers. The emphasis of the spin-off strategy is to divest the social assets in SOEs as an independent company with diversified ownerships. By 2004, 143 spin-off programmes were identified and approved in 25 companies, and of which, 32 spin-offs in 15 companies completed. In 2004, 20 companies were closed down, 7 companies divested and bankrupted. 20 companies will be closed down or bankrupted, and another 20 firms be spun off and the subsidiary businesses be separated from the core businesses.

Liu Jibin, Minister of COSTIND claims that shareholding reform is the best solution for loss-making enterprises, which are now a common member of market and no longer the apple of the state's eye.[60] The shareholding reform has been carried out in CSIGC, 2-3 qualified enterprises will be restructured as shareholding companies; and another 2-3 firms will complete debt-swap-to stock programme. By 2005, 47 companies will participate in the restructuring programmes, which involve total assets of about 15.1 billion Yuan, debts of 12.1 billion Yuan, 140,000 workers, and 58,000 retired workers. By carrying out the strategy, it is expected that CSIGC will get rid of 800 million Yuan debts.

In the meanwhile, corporate governance structure is required to be developed in the restructured companies. In enhancing the process, CSIGC has decided to implement the system of chief accountant assignment, and set up office of board of directors to improve accounting standard and information transparency, and protect shareholder

[59] BBC Monitoring Asia Pacific – Economic, "China drives enterprise reform by allowing more mergers, bankruptcies", London, August 3 2000.

[60] China Daily, "Defence industry eyes foreign cash", New York, July 4 2001.

rights and interests, as well as state assets.

Restructuring and Firm Performance

As a result of the restructuring and reform over the past six years, CSIGC was able to reduce the deficits of the enterprises through the adjustment of production capability, strategic enterprise restructuring, and policy support from the Central Government.

Table 8-6 shows that the 64.5 billion yuan of total sales were generated in 2004, of which, sales of industrial production were 45.4 billion yuan, it was 2.68 times over the industrial sales in 1999, average 22 percent of annual growth over the past five years. In particular, in recent two years, the sales grew to 40%, CSIGC was the fastest growth company in the 10 defence industries. The value-added of industry amounted to 9.2 billion yuan, which were more than 3.1 times of 1999. The labour productivity also increased from 13,200 yuan/per person to 60,000 yuan/person.

Table 8 - 6 Comparison of Financial Performance in 1999, 2003 and 2004

Indicator	*1999*	*2003*	*2004*
Sale (100 million)	n.a.	500	645
Industrial sale (100 million)	169	337	454
Value-added of industry (100 million)	29.9	73	92
Labour productivity (10,000 Yuan/per person)	1.32	4	6
Employment (person)	228600	134784	
Production of Vehicle (10,000)			
Automobile (10,000 vehicles)	14	58	41
Motorcycle (10,000 vehicles)	n.a.	306	189
Sale of Optical-electronics products (100 million)	n.a.	n.a.	15.2

Source: Annual Conference Reports 2004 and 2005.

The operating performance in recent years is shown in Table 8-7. We found that the sale growth was up from 23% in 2001 to 28% in 2004. CSIGC was ranked 31 in China Fortune500 in 2004, increased 11 levels compared to 2001, and ranked 8 in China Manufacturing Industries. Compared with other defence industries, CSIGC was rated as a number one in 7 defence industries of China Fortune500; number four in the automobile industry of China500; number one in the motorcycle industry of China Fortune500. This implies that CSIGC have relative advantage in the core competencies over others.

Table 8 - 7 Financial Performance of CSIGC 2001-2004

Year	Sale	Sale growth	profit	Profit growth	assets	employees	Rank
2001	2508482	23.49	-46022	43.45	4855526	205762	42
2002	3969218	20.22	6522	121.29	7506347	187763	33
2003	5015909	26.37	-88380	-86.75	7616559	134784	33
2004	6435475	28.30	86838	656.82	7792612	1121230	31

Source: China Report of Chinese Enterprise Report 2002, 2003, and 2004. Rank refers to China Fortune500, which was rated in the Report.

CSIGC's insistence on combination of the military and civilian has brought about productive results. Table 8-6 also reveals that CSIGC has become the third largest automobile production in terms of sales in China's market. In 2004, 580,000 vehicles were sold, which was 4.14 times more than the sales of 1999 (140,000 vehicles), the sales of motorcycles always maintain the number one in China. The emerging enterprises in the fields of auto parts, optical-electronics, medicine, chemicals, and engineering machine have also improved their operating performance. This trend is shown in Table 8-8, where it reveals sales growth of the most two key motor companies, Chang'An Automobile Co. Ltd and Jialing Motorcycle Industrial Co., Ltd, and one optical and Electronics Company, Tianxing Instruments and Meters Co., Ltd. All these improvement in firm performance laid down a solid foundation for the group to strive to fulfill the "622 Development Strategy" in the coming years.

Table 8 - 8 Financial Performance of Motor and Instrument Companies 1999-2004

Indicator	*Firm Name*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*
Employment (person)	Chan-An Automobile Co. Ltd	8563	7874	7135	7077	7532	7944
	Jialing Industrial Co. Ltd	8995	4829	4378	4548	4230	4137
	Tianxing Instruments and Meters Co. Ltd	2519	1620	1286	1174	1176	1167
Total assets (100,000 Yuan)	Chan-An Automobile Co. Ltd	709392	757167	663675	870273	1090807	1469206
	Jialing Industrial Co. Ltd	350249	385431	399431	377183	382797	391292
	Tianxing Instruments	29868	33239	35729	24210	25841	27852

	and Meters Co. Ltd						
Sale (100,000 Yuan)	Chan-An Automobile Co. Ltd	544676	670321	733181	988407	1440412	1852660
	Jialing Industrial Co. Ltd	331129	257252	259051	288733	298589	329200
	Tianxing Instruments and Meters Co. Ltd	9977	7928	5113	6262	8132	11966
Net profit (100,000 Yuan)	Chan-An Automobile Co. Ltd	5372	14765	16022	83500	145068	131730
	Jialing Industrial Co. Ltd	5272	234	975	-16806	561	1265
	Tianxing Instruments and Meters Co. Ltd	9977	7928	5113	6262	8132	11966
Leverage (percentage)	Chan-An Automobile Co. Ltd	60.40	60.00	53.30	51.20	47.90	44.75
	Jialing Industrial Co. Ltd	56.20	63.10	65.70	68.30	68.90	69.51
	Tianxing Instruments and Meters Co. Ltd	25.80	37.70	54.80	55.00	56.60	59.52

Source: Annual Reports.

Social Issues Caused by Organizational Downsizing

Efforts to rationalize and downsize China's large, bloated, and inefficient defence enterprises raise concerns about social stability, especially increasing unemployment, inability to fulfill pension commitments, and cutting off funding for enterprise-run social welfare programs. The 1998 reforms eliminated a number of the social welfare obligations of many state-owned defence enterprises, such as housing and health care. However, the managers of some defence enterprises have been reluctant to implement these reforms for fear of the impact on social stability. Riots and social unrest related to rationalization at defence factories have already occurred in China. Such concerns will likely limit the pace and scale of defence enterprise reform.

The policy made by COSTIND in 1998 requires that the employees and workers in the defence industry must be downsized from 2.07 million by the end of 1998 to 1.5 million in the years to come. The labour force in the defence industry should be determined by the principle, which is that the production capability should be determined by the sale, and the number of workers/employees needed in the company should be by production capability. It was requested to take aggressive measures to downsize and displace the workers. In the meantime, it defines the social support programme for re-deployment of laid-off and unemployed workers as a result of enterprise restructuring with downsizing.[61]

The downsizing trends can be found in Table 8-6. Table 8-6 shows that since 1999, 93816 workers have reduced through downsizing, early retirement, and other channels. 27,000 redundant workers were laid off in 2001 (Yang 2002). 3 companies in Table 8-7 have also reduced their workforce at about 20-30 percent.

Table 8 - 9 Survey Result of Enterprise Restructuring 2003-2004

Item	Total	To great extent	To some extent	To little extent	Not at all
1. Employee involvement	55	83.6	10.9	5.5	0.0
2. Local community involvement	55	60.0	25.5	3.6	10.9
3. Government involvement	55	50.9	36.4	5.5	7.3
4. Communication with employees	55	54.5	40.0	3.6	1.8
5. Innovative production initiatives	55	58.2	29.1	10.9	1.8
6. Workforce reduction	55	30.9	29.1	14.5	25.5
7. Social programme provided for redundant/lay-offs	55	80.0	18.2	1.8	0.0
8. Lay-offs deployed after restructuring	55	69.1	25.5	5.5	0.0
9. Labour disputes in the restructuring	55	3.6	38.2	58.2	0.0
10. Approaches employed in the restructuring	55	12.7	41.8	45.5	0.0
11. Social functions split off from firms	55	5.5	5.5	45.5	43.6

Table 8-9 reveals that most of enterprises of CSIGC have suffered substantially workforce reduction. However, thanks to the socially responsible approaches CSIGC undertook in the restructuring, the social support programmes were designed to assist lay-offs to find new jobs, for example, and 13,800 people found new jobs in 2001 (Yang 2002). Table 8-9 also shows that restructured firms have substantially involved government, communities and employees in the restructuring, communicate frequently

[61] COSTIND, "the Guideline of Consolidating the Work on Laid-off of Workers and Re-employment", No. 675, 29 November 1999.

with employees with restructuring information. Importantly, they have created more jobs through open new production lines and developing new products.

Social Support Programme for Lay-offs and Unemployed Workers

Strategies and principles laid by the central authorities, which are "encouraging M&As, regulating procedures of bankruptcy, laying off and displacing workers of SOEs, downsizing employees to improve profitability and efficiency, and in the meantime, carrying out re-employment project for lay-offs and the unemployed". And also set up the system of "Security on Three Fronts" (*Bao Zhang Xian),* which includes basic livelihood guarantee for lay-offs of SOEs, unemployment insurance, and minimum livelihood guarantee for urban residents.

Implementation of Re-employment Programme through various channels

Re-employment Training shall be provided for the lay-offs and unemployed workers as a result of restructuring to improve employability and vocational skills. The training focuses on areas related to start-up business and skills in the service industry. The group corporations should provide financial supports for the training programmes.

The tertiary industry is encouraged to be developed to create more jobs. The particular attention should be paid to community service trade, focusing on services for community residential living; logistics and security for institutions, enterprises and units, and community public management; and jobs of public, cleaning, greening, and maintenance of public facilities.

Individual, private, foreign-funded, cooperative-share and other forms of economic ownership system are encouraged to expand employment, actively develop labour-intensive SMEs to continue to develop labour and employment service enterprises to absorb more laid-off and unemployed workers.

Trans-regional labour cooperation and export of labour service to foreign countries should be encouraged.

Start-up new business

Employees in the enterprises who know business and management, and have professional expertise are encouraged to develop their own business. The privilege and assistance shall be offered, provided that the economic entities they develop can re-deploy laid-off and unemployed workers over 60% of total employees.

The managers shall be provided with working capital in the name of enterprise. The managers will be compensated with annual package, or rewarded by the return from the profit after tax when their businesses have been profitable for three years. The compensation, and rewards are closely linked to the firm performance, which shall be evaluated on the results of the maintenance of state assets values, redeployment of laid-offs and income tax they pay to the state.

The individual-owned and private business shall be encouraged to develop. The owners can maintain the labour contracts with their enterprises for 3 years, and the social insurance can be managed and paid by the enterprises.

Self-employment

The laid-off and unemployed workers are encouraged to be self-employed or start up business with others. The self-employed workers, who break up labour relations with enterprises, shall be compensated according to the relevant laws and regulations.

The laid-off and unemployed workers as a consequence of enterprises bankruptcy, closed-down, and transfer undertaking, they shall be compensated in the lump sum against criteria of some regulations for their self-employment, and also be exported to other regions for employment.

Early retirement

Those who want to take voluntarily 10-year early retirement; they can sign a contract with enterprises to maintain their social insurance. Contributions to the social security shall be made on the based of agreed rate. Those who want to take voluntarily 5-year early retirement, after being approved by enterprises, they can take early retirement and leave the enterprises. They will be provided with living allowance. Contributions to the social security shall be paid by both individual and enterprise according to some regulations. After 5 years, they are entitled to enjoy full retirement benefits.

Consultancy and information on Reemployment

It is required that all the institutions for the enterprises should keep in touch with enterprises, and provide consultancy and information about policies and practices that the state develop for re-deployment of laid-off and unemployed workers. The institutions also should provide labour market information about the job vacancies, re-training, and counselling and vocation guidance.

8.4. Spin-off of Social Assets: Yangtze Chemical Plant Experience

8.4.1. Introduction

The Yangtze Chemical Company (YCC) was built in Jiujiang, Jiangxi Province in 1962, and it is one of the defence SOEs under CSIGC engaged in the research and production of non-metal synthetic materials. YCC now has seven manufacturing factories, 2 subsidiary plants, and one R&D institute, with total assets of 220 million RMB (US$ 27.16 million), and 2000 workers and employees.

YCC is located in remote isolated region; it has developed a comprehensive system of social services in the past 40 years, covering the cradle-to-grave responsibility for their employees and community it operates. Like other defence SOEs, YCC took full responsibility for providing a wide array of social services for their employees and community, such as housing, education, day care and medical care, etc. Many departments and institutions were set up within YCC to provide such social services as school, hospital, kindergarten, administration, maintenance, hotel and catering, transportation, retirement office, residence council, etc. YCC acted as the dual role of government and enterprise in the company town. To play the role of government, YCC had to meet the social needs at the cost of less profit; to play the role of enterprise, and to succeed in the increasingly competitive market, YCC must concentrate on profit-maximization. These roles were often conflicting; therefore, separating the role of providing social services from the core business operation was an important strategy to modernize SOEs.

In line with the requirements of the central government and CSIGC, all the qualified large and medium-sized SOEs shall divest the social assets from the core operation into independent subsidiary, undertake ownership restructuring in the spun-off subsidiary company in order to displace and re-deploy lay-offs. [62] YCC initiated internal restructuring in 2002 through divesture of social assets including most of the social services and staff.

8.4.2. Theoretical Background - Divesture of Social Assets from Core Business

The problem of enterprise social assets is one of the most important issues facing enterprise restructuring. The extensive provision of social services to both employees and general public in surrounding communities diverts enterprises from their core activities. Financial and administrative burdens associated with social services raise costs and prevent enterprises from being competitive. Social assets are considered as an additional barrier for external investors who might refrain from investments in enterprises with large social liabilities. Additionally, in cases where large potentially insolvent enterprises provide a number of social services to their communities, it increases the bargaining power of such uncompetitive enterprises vis-? vis governmental authorities. It makes it very difficult for bankruptcy procedures to be initiated against them, and forces the state to continue to subsidize them. Users of enterprise social services are often not protected enough from arbitrary actions of enterprise managers and a general deterioration in the level of provided services. The downsizing of enterprises' social activities means that some other agents will have to perform these functions in their place. That is why the issue of enterprise social assets is not only one of the crucial components of industrial restructuring, but also is closely connected with both public and social sector reforms. There are a number of purposes for the public sector's involvement in substituting enterprise social functions: (i) protection of some critical elements of public services (e.g. kindergartens), which might otherwise disappear due to reductions in enterprises' funding; (ii) facilitating of reforms in both housing and delivering mechanisms for some public services (e.g. health services), which would be easier if all corresponding assets were temporarily concentrated under the management of municipal governments; (iii) guaranteeing

[62] "Outline of Propaganda on Further Accomplishing Re-employment Work for Laid-off and Unemployment Workers", CCP Central Committee Propaganda Department and Ministry of Labour & Social Security, 29 October 2002.

adequate access for citizens to important public services, largely because social activities of enterprises are sometimes delivered at a much higher, sometimes at a much lower, level than public ones; (iv) financial savings through rationalization of management and provision of services. At the same time, some former enterprise social assets could be either privatized or used to introduce new institutional reforms in the public sector. These assets are not necessarily to be transferred to existing public governance structures and fall under the control of prevailing interests therein. So, the divestiture of these assets could make them pioneers in social sector restructuring and, therefore, might facilitate social sector reforms in general (Freinkman and Starodubrovskaya 1996).

In the transforming and conversion of defence production in the 1990s, YCC had attempted to transfer social assets to the public sector through different approaches for many times such as contract responsibility, and director's responsibility, since property rights over a major part of social assets, most notably housing, were not properly defined as the transfer decisions were largely left for the local level players to make. It failed to succeed in divesture of social assets. After many years' SOE reform, a considerable amount of housing and other social assets were still within YCC. After the efforts to transfer these assets from firm to the public sector in the mid 1990s, this phenomenon has not received much attention. YCC still provided a wide array of social services or finance them despite having divested of them. By 1997, YCC was still retaining 10 departments which offered the social services such as school, hospital, child care, administration, facility maintenance, hotel, transportation, retirement office, and local community office. The staff in the departments accounted for 11.3% of total workers in the firm, and overhead for 24.7% of total operating expenses of business. All of the social service provision became the heavy burden on preventing the firm from further reform and development. In 2002, in line with the CSIGC restructuring plan, YCC launched the restructuring programme with a special focus on divesture of social assets from the core business of firm, and got rid of the debt. The main objectives of the social services restructuring was to enable survival of the existing services; to retain workplaces; to improve the effectiveness and quality of services; to divest social services into a new economic entity, and to gradually reduce the subsidies provided by the firm.

8.4.3. Spinning off Social Assets into an Independent Subsidiary

In 2002, complying with the requirements of central government, under the guidance of CSIGC, YCC launched enterprise restructuring to spin off the social service. The social services (e.g. the 10 departments) were divested from YCC and were reorganized as a separate company "Yangtze Chemical Community Co. Ltd Corp. (YCCCL)" with its own management and supervisory council.

Spin-off of Social Services

Prior to the implementation of divestiture, YCC designed and issued necessary documents in line with China Corporate Law, such as "Project for Establishment of YCCCL", "Company Charter", "Shareholding Scheme", "and Methods of Employee Shareholding Programme". The documents were regarded as the guidelines for the restructuring. In the meantime, the social assets of 10 departments were evaluated and audited by the accounting agency and State Assets Supervision and Management Office. The total social assets were about 1.902 million Yuan, and established the working capital of the new venture in total of 2.350 million Yuan (with the contribution of 0.448 million Yuan from the mother company). The "Shareholding agreement" were passed and approved by the Workers' Council. On the agreement of the people to be transferred to the new company, their severance payment had been converted into the capital shares, which made them the shareholders of YCCCL.

106 employees and workers in the social service departments voluntarily broke up with the parent company, and signed labour contracts with YCCCL, they were allowed to enjoy non-interrupt working age, pension, medical and unemployment insurance. According to the new Employee Share Ownership Programme (ESOP), seven shareholding commissioners were elected by the members to represent the interests of the stockholders. The workers shareholding capital (1.2633 million Yuan in total) constituted 53.76% of the total capital stock. The capital invested by the parent company in the form of the main assets in value -1.0867 million RMB constitutes 46.24% of the total share capital.

YCCCL was given self-sufficiency and required to develop new business from third parties to compete with other companies in the market. It was also allowed to bid for the contract to supply the inputs. The new businesses that YCCCL develops cover management of community, resident service, medical service, logistics, construction and maintenance, hotel management, transportation of materials, provision of gas and electricity, and glass and metal production. YCCCL can sell its services and outputs to a third party at a higher price.

Table 8 - 10 JiuJiang Yanterze Chemical Company 1998-2003

(10,000 Yuan)

	1998	*1999*	*2000*	*2001*	*2002*	*2003*
Employment (person)	2468	1931	1883	1800	1714	2000
Assets	17938	19169	18142	18048	18219	22000
Sales	3318	5015	8030	7509	7308	7670
Net profit	626	670	1258	1505	1584	1698
Leverage (%)	70.97	64.51	64.89	62.53	60.80	58.65

Source: Provided by the YCC in the interview

After the divesture of social assets into a new firm, meaningful improvement of quality has been made. Table 8-10 shows that the operating performance of the parent company has been improved in terms of the sales growth (131% against 1998), and growth of net profit (171% against 1998), the leverage reduced from 71% in 1998 to 59% in 2003. The direct costs of social services have been declined and the subsidy cut down 20% by the parent firm. The workforce was substantially cut down from 2468 to 1714 workers, however, due to development of new production lines and upgrading of the existing production lines, more jobs have been created. The newly-established company has expended the scope of services to cover more areas which are in need of company and local community, for example, in addition to the traditional services, home sickbed service, home furniture maintenance, home food delivery can be provided by the new firm. In particular, in joint collabouration with local authority, the foreign language school, and kindergarten centre have been built to provide education for the companies and open to the public. The workers in both parent and subsidiary firms have improved their responsiveness and innovativeness, and were willing to take more responsibilities. The parent company has also benefited from rerouting the considerable managerial and financial resources for development of its core activities.

Restructuring Corporate Governance

Transition from social service departments to a modem corporation involves restructuring the corporate governance. In line with "YCCCL Company Charter", YCCCL diversified its ownership structure from the sole state ownership to multiple ownerships including employee ownership, institutional ownership, and even foreign shareholder ownership. After completing the restructuring process, YCCCL developed corporate governance structure, which is composed of shareholder Assembly, board of directors (BOD: 7 members), board of supervisors (BOS: 3 members). Three members of BOD shall be recommended by the parent firm, and the rest of four members elected by shareholders. It was required that the board of chairmen of directors and supervisors should be elected by the shareholding meeting, and directors-general shall be nominated by chairman of BOD, and approved by BOD. Although the parent firm was required by the government to provide a limited contribution to the social services in the transition period, it has no control over the new firm.

Socially Responsible Practices in Restructuring

YCC started restructuring in October 2002, and successfully completed the divesture by the end of 2003. There were no any public protest action, no single appeal to the higher authorities on behalf of the personnel thanks to the socially responsible practices and well-defined strategy the management implemented during the whole restructuring process.

Involvement of Stakeholders

Prior to implementation of restructuring, YCC identified the main stakeholders, i.e. employees, local authority, local community, workers' representatives and other institutions who may be affected by or influence the design, implementation, and outcomes of restructuring, and then a working group was set up to agree on a consistent policy for restructuring, including to what extent "exceptional" safety net initiatives beyond the current provisions of social safety net programmes should be recognized; to adopt legal framework of restructuring; to clarify responsibility of the local authority and management in divesture of social assets; to assess the capacity of the local authority in restructuring strategies such as income support and labour redeployment schemes, and to develop a consistent communications strategy for restructuring based on stakeholder analysis.

Preservation of the workers rights and benefits

As I described previously, divesture of social assets is usually followed by staff downsizing. 160 workers working in 10 social service departments were displaced, and voluntarily broke up with the parent company. But all of them were redeployed in the new firm with new contract and status of employment. All the benefits of the workers were retained in the newly established company such as working age and pension benefit, medical care and social insurance.

Open communications and discussions were frequently conducted with employees who were influenced at the preparatory and implementation stages of the project. The management provided the clear vision of the future of the new company and the role of each individual, and the guaranty to the individual of the preservation of their workplaces. The displaced workers from the parent firm were allowed to participate in the new company share ownership via ESOP. Regular information on the progress of restructuring was communicated to employees and local community.

Improvement of motivation and responsibility of workers

ESOP is the best way for YCC to motive the employees to be more involved in policy-making, and become more productive, resulting in a sustained improvement in company performance. ESOP aligns employees' interests with those of shareholders, and retains or recruits key employees, increase loyalty and reduce staff turnover and raise working capital. ESOP in conjunction with employee involvement encourages employees and employers to work together to achieve the long-term success of the business. Employee share ownership might also be expected to lead to a better informed workforce who takes a close interest in the performance of the company and who also become more adept at understanding financial and accounting terms and practices.

The YCC as a key agent of local community development

The community that YCCCL operates had heavily relied on YCC to provide all the services in the past years. In addition to employees and workers, there were also over 1300 retired workers and 2000 families who live in the community. Thus, it's important to sustain the development of community after restructuring. YCC consistently live up to the main mission when they undertook restructuring, which was: serving the community; improving community facilities and functions; contributing to development of local economy; and contributing to the prosperity of community

Since its foundation, the new company undertook the following voluntary initiatives: first, it set up the Community's Representatives Committee of Public Security; community's real estate house property development network; environment control and fire prevention and fighting network, rebuilding of the dormitory for single workers; support of the families with the lowest income; arrangement of the public cultural and sport events. It's planned that by 2006, YCC devotes its effort and resources to developing a brand-new community with expanded new streets, improved ct environment, harmonious neighborhood, and more secure and orderly surroundings.

8.5. Conclusion

In this chapter, I examined to what extent SOE restructuring was undertaken in a socially responsible manner by investigating the case study of defence industry. The case study was designed to illuminate how socially responsible restructuring was carried out from the perspectives of macro-level (state) and micro level (firm). From the macro point of view, I described the strategies and policies which were developed for reshaping China's defence industry, with a special focus on SOE reform and re-organization in defence industry. Reviewing evolution of Chinese defence industry provides us the background of what the issues and challenges the defence industry were facing, and why it was essential for China's leadership to put forward the policy to restructure defence industry. Then, in this context, it is easy for us to have a better understanding of the specific strategies and policies designed by CSIGC which was analyzed at the micro level.

In second part, I analyzed the perceptions of the managers toward CSR, and the relationship between the managers' attitudes and their socially responsible behaviours in restructuring. Although I can't draw definitive conclusions about the relationship between the attitudes of managers and socially responsible behaviours they might perform in the restructuring activities on the basis of a case study of just one company, it suggests that socially responsible values-oriented managers pay more attention to social issues in restructuring than other managers. The results show us that the managers in CSIGC were more aware of CSR concept, and consider it's important for a firm to engage in socially responsible activities. The survey also shows that managers in CSIGC regard employees, customers and government as their most important stakeholders, and pay attention to establish good relationships with them. The survey also indicates that in the context of Chinese SOEs, the necessary support measures and programmes should be taken during the pre- and post-restructuring; for example, consultation process involving employees, trade unions, representatives of local government should be conducted. The parties should be involved as early as possible. Early communication and consultation with employees and other stakeholders concerned is important to ensure fairness and transparency of the restructuring process.

In the third section, focus was put on the analysis of the case study at the group level and plant level. At the group level, strategy and policy developed for restructuring were described, and the impact of restructuring on firm's performance was economically and socially evaluated. At the plant level, the special attention was placed on the restructuring by divesture of social assets into an independent firm at Yangtze Chemical Company. The successful restructuring programme attributes to the socially responsible practices YCC took during the restructuring. For example, the stakeholders, which were affected by the spin-off, were identified and kept involved at the working group to discuss policy and strategy for restructuring and re-deployment of lay-offs. Employee Share Ownership Programme was introduced to align employees' interests with development of spun-off firm, and to motivate them to take more responsibility for improvement of firm performance. The necessary measures and practices were taken to preserve the workers' rights and benefits after the spin-off. Local community development was always put on high agenda of firm management during the restructuring. The newly-established company was served as a key agent in promoting the community development and property; therefore, more new services and facilities were developed and constructed after the restructuring. Overall, the both restructured and new firms have made much more contributions to the prosperity and stability of local community.

Chapter 9 Conclusion and Implications

9.1. Summary

The financial performances of enterprises in China have deteriorated markedly over the past years. The majority of SOEs are at best marginally profitable and a large portion of collective enterprises were also in serious financial difficulties. The poor financial performances were attributable to a range of factors. These include excess capacity built up during the investment boom earlier in the 1990s; heavy financial burdens from high debt loads, surplus labour, and social welfare expenses normally borne by government or society at large in other countries. The government, therefore, came up with a new restructuring strategy to speed up China's enterprise reform. One strategy was to improve financial performance by getting rid of bad debts, laying off redundant workers, and hardening budget constraints in the short term; with the ultimate goal of achieving sustained improvement in efficiency and competitive viability in the long term.

Radical restructuring and privatization, coupled with irresponsible actions of firms, brought severe problems of social instability, and a wide range of stakeholder reactions like labour protests. Issues of social responsibility arising from restructuring, therefore, have increasingly gained the attention of governments, management and academic researchers. Against that background, this study set out to empirically explore the phenomena of CSR, socially responsible restructuring and firm's performance in Chinese enterprises.

The study has three parts. The first part investigates managers' attitudes towards CSR and relationship between managers' attitudes and their behaviours in restructuring. The data for this analysis was collected by the structured survey in the sampled firms in 2003-2004. The second examines relationship between socially responsible restructuring and firm's performance in the listed firms over the seven years (1997-2003). The third is a case study of a state-owned defence industry restructuring. The case study is to give comprehensive and deep insight into the CSR issues, and to help us to have a fuller understanding of the phenomena and process of socially responsible restructuring in China.

Chapter 2 and 3 provided the theoretical, conceptual and country-specific context for this empirical examination of the Chinese case. The major theoretical fields relevant to this study were reviewed and analyzed. CSR is one of the key concepts in this research. CSR means companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis. The dimensions for measuring socially responsible performance were identified, and the previous researches on relationships between CSR and financial performance were examined. The second important area is enterprise restructuring. The concept of restructuring was clarified. The review of this field focused on what factors influence the degree of socially responsible performance in restructuring. The factors were used as indicators to determine socially responsible performance. Corporate governance is another key concept in this research. The review of corporate governance is to identify how the different corporate governance models (shareholder vs. stakeholder models) influence the degree of socially responsible performance in restructuring. All the main concepts and definitions were built on the stakeholder theory and model. The stakeholders are the core concept, which is integrated in all the areas in this study. Chapter 3 presents the macro-economic background, and Chinese government's reform strategies and policies over the past years. It also examined the issues and problems that enterprise reforms were facing and how the government was tackling them.

Chapter 4 and 5 presented the conceptual framework and methodology of the study. The framework linked socially responsible restructuring and firm's performance to the four key aspects in literature review, including CSR, enterprise restructuring, and corporate governance, and socially responsible restructuring. The framework was used as an instrument for structuring survey design, collecting and analyzing data.

Chapter 6, 7 and 8 presented the results of three empirical examinations. The first examined the managers' attitudes toward CSR, and the relationship between managers' attitudes and their behaviours in restructuring. The second explored relationship between socially responsible restructuring and financial performance, and the sources of changes in financial performance after restructuring. The third was a case study of defence industry restructuring. It illustrated how a Chinese firm attempted to balance the economic and social priorities in enterprise restructuring, and to provide us with an insight into how socially responsible restructuring can be successful.

9.2. Conclusion

9.2.1. Attitudes of Managers toward CSR

The management survey examined the managers' attitudes toward CSR, stakeholders and socially responsible restructuring. The emphasis was on investigating the factors that influence the managers' attitudes, and whether managers who hold socially responsible values tend to behaviour in a more socially responsible manner in restructuring.

The result of the survey demonstrated that a large proportion of respondents (about 60%) have a better understanding of the concept of CSR and are moderately in favour of CSR. It implies that CSR has gained higher awareness among the Chinese managers in recent years, and are willing to engage in socially responsible activities, and integrate CSR in firm's business routine activities.

The survey also illustrates that in the context of current economic development, the managers allocated more responsibilities to such main three stakeholder groups as government, customers and employees, because these groups have great impact on their reputation and the firm's performance. The managers recognize that the benefits of being a good corporate citizenship which enjoys attracting the best employees, winning deep-seated customer loyalty, minimizing lawsuits, and possibly lowering the cost of capital. The managers tend to create harmonious relations with these groups, and provide quality products and services for customers, create favourable working environment for employees, and contribute more tax to government.

The result implies that higher levels of managers' knowledge about both social responsibility issues and the social responsibility records of firms influence managers' socially responsible behaviours. The regression analysis shows that the managers' age and education are the main factors that influence their attitudes toward CSR, the older and highly educated managers are more in favour of CSR; the managers who hold highly socially responsible oriented values attach more importance to socially responsible practices, and act in a more socially responsible manner in restructuring.

9.2.2. Socially Responsible Restructuring and Firm's Performance

The results of the empirical examination of relationships between socially responsible restructuring and financial performance are significant and have more implications. First, the major theories concerning social responsibility which had been developed in a developed-economy context, were tested within the distinct cultural and economic environment of China. The second, a multi-dimensional measure of CSP was used, which allowed for a more comprehensive measurement. The results support some of the postulated relationships between CSP and financial performance in restructuring. More socially responsible performance leads to better financial performance in restructuring.

This study supports the researches undertaken previously (McGuire *et al*, 1988, Rosen et al , 1991, Graves and Waddock, 1994, and Pava and Krausz 1996). The results of those researches argue that there is a positive association between financial performance and CSR. The event study of Frooman (1997) shows that for firms engaging in socially irresponsible and illicit behaviour, the effect on shareholder wealth is negative (wealth decrease).

The results of this study show that after restructuring, the financial performance of firms wasn't significantly improved, but sales efficiency was increased. The results are inconsistent with the growing empirical evidence that after privatization/restructuring in transition economies, firms become more profitable (Megginson, *et al* 1994; Narjess and Jean-Claude 1998; D'Souza and Megginson 1999; Wei, Oscar, Juliet, and Hassan 2003; Huang and Song 2005; Boubakri, *et al* 2004). However, the study did confirm the result of the research done by Wei, *et al* (2003), which argues that in China, there is general trend towards decreased profitability after privatization/restructuring.

9.2.3. Balancing Economic and Social Priorities in Defence Industry Restructuring

The case study was designed to illuminate how socially responsible restructuring has been carried out from the perspectives of macro-level (state) and micro level (firm). From the macro point of view, I described the strategies and policies which were developed for reshaping China's defence industry, with a special focus on SOE reform and re-organization in defence industry. Reviewing the evolution of Chinese defence industry provided the background to the issues and challenges the defence industry faced, and why it was essential for China's leadership to put forward a policy to restructure defence industry. It gave us a better understanding of the specific strategies and policies designed by China South Industry Group Corp. (CSIGC) which was analyzed at the micro level.

The results show that the managers in CSIGC have become more aware of CSR, and consider it important for a firm to act in a socially responsible way. The survey also shows that managers regard employees, customers and government as their most important stakeholders, and pay attention to the relationships with them. The survey indicates that Chinese SOEs should take support measures before and after restructuring; for example, launching a consultation process involving employees, trade unions, local government representatives as early as possible. Early communication and consultation with employees and other stakeholders concerned is important to ensure fairness and transparency in restructuring process. Voluntary redundancy arrangements and benefits can reduce workers' resistance to restructuring and facilitate transition. After restructuring, the temporary income support programmes (e.g. unemployment benefits, unemployment assistance, social assistance, early retirement schemes) should be offered to the displaced workers and employees, so that they can maintain the basic living standards and have time to do job research.

At the group level, strategy and policies of restructuring were described, and the impact of restructuring on firm's performance economically and socially was evaluated. In particular, I examined the social support programme CSIGC designed for restructuring. At the plant level, I paid the special attention to the restructuring achieved by divesting social assets into an independent firm in the Yangtze Chemical Company. The socially responsible practices YCC developed contributed to the successful restructuring. For example, the stakeholders, who were affected by the spin-off, were kept involved at the working group to discuss policy and strategy for restructuring and re-deployment of lay-offs. An Employee Share Ownership Programme (ESOP) was introduced to align employees' interests with development of spun-off firm, and motivate them to take more responsibility for firm performance improvement. Measures were taken to preserve the workers' rights and benefits after the spin-off. Local community Development was always put on high agenda of firm management in the process of restructuring. The newly-established company was served as a key agent in promoting the community development and property. Both restructured and new firms have made much more contributions to the prosperity and stability of local community.

9.3. Implications

I conclude the study by discussing some implications for academics, practitioners and policy-makers. For the academic world, this is the first study that explores the phenomena of CSR and firm's performance in restructuring in China from the various perspectives: how do the Chinese managers perceive CSR and whether their attitudes influence their behaviours in restructuring? Whether the firms with more CSR outperform the firms with less CSR? The study provides more evidence that there is a positive relationship between attitudes and behaviours; and there is a positive association between socially responsible performance and firm's performance in restructuring. The first contribution of the study to the academic literature is that it fills the gap in the research on relationships between CSR and financial performance in the developing world with the specific Chinese case. The study in this field used to concentrate on Fortune500 and to be dominated by the researches in the developed world. Another contribution is to launch a new research issue: CSR, business ethics and firm performance in the context of transition economies like China's. More specifically, the study constructs the multi-dimensions of CSP built on the stakeholder model which can be used as indicators for measuring socially responsible performance in restructuring.

For managers and executives, the results, in line with the previous studies, suggest that CSR challenges businesses to be accountable for the consequences of their actions that affect the firm's stakeholders while they pursue traditional economic goals. The firms involving CSR activities may benefit from social responsible actions in terms of employee morale, customer loyalty, etc.. A firm perceived as being socially responsible may face relative few labour problems, and customers may be favourably disposed to its products. Social responsible activity may also improve a firm's standing with such important constituencies as bankers, investors, and government officials. Improved relationships with these constituencies may bring economic benefits. High CSR may therefore improve a firm's access to sources of capital whereas low social responsibility may increase a firm's financial risk. Investors may consider less socially responsible firms to be riskier investments because they see management skills at the firm as lacking. Investors and other constituencies may also anticipate an increase in firm costs owing to lack of social responsibility. For example, the government may levy fines, and law suits may be filed as this study shows. In contrast, a high degree of CSR may permit a firm to have relatively low financial risk as the result of more stable relations with the government and the financial community.

However, being socially responsible does not mean that a company must abandon its primary economic mission, nor does it mean that socially responsible firms cannot be as profitable as other less responsible. Social responsibility requires companies to balance the benefits to be gained against the costs of achieving those benefits. For public policymakers, this study and the experience from other countries suggest that government has an important role to promote the business case for CSR, and provide leadership by helping to achieve consensus on overall vision and on priorities for action whilst recognizing the very diverse interests of the stakeholders involved. It can also ensure that it fosters a climate that encourages business to adopt CSR and does not inadvertently introduce barriers that prevent business from engaging in CSR.

9.4. Directions for Future Research

Socially responsible investing (SRI) increasingly assumed a major role in the global financial markets, it raises numerous research questions about the processes through which SRI advocates have succeed in convincing investors to adopt socially responsible forms of investing. Some researches argue that the continued growth in investors seeking to align their ethical concerns with their investment strategies may influence the way in which the restructuring activity is managed in the publicly-listed firms.

Although theory and research have focused primarily on the relationship between CSR and FP, an argument for a relationship between CSR and such measures of financial risk as variance in earnings and in stock returns can also be made. First, low levels of CSR may increase a firm's to be riskier investments because they see management skills at the frim as low. Investors and other constituencies may also anticipate an increase in firm's costs owing to lack of social responsibility. Perceptions of low social responsibilty may also decrease a firm's ability to obtain capital at consistent rates. A high degree of CSR may permit a firm to have relatively low financial risk as the result of more stable relations with government and financial community. A firm with high social responsibility may also have a low percentage of total debt to total assets. Firms with high social responsibility may have lower market- and accounting-based total risk because they are less sensitive to certain external events, like governmental actions and have a lower debt. The global rise in SRI is consistent with the broader movement of shareholder activism whereby shareholders exercise their capacity to become more involved in the strategies, objectives and activities of corporations. There are some SRI funds that file shareholder resolutions on behalf of their investors and use proxy votes to alter the behaviour or actions of companies they have invested in.

The future research shall further explore, to what extent, social performance of restructuring (M&A) is influenced by SRI. SRI is the practice of making investment decisions based on both financial and social performance (Shapiro 1992). Potentially, it is a powerful way for investors to promote and reward firms whose behavior is socially responsible, although to date, the investor's ability to affect social change through investment decisions has been limitted. Institutional investors believed that low CSR companies tended to be involved in litigation, industrial action and /or suffer from goverment imposed fines and sanctions; high CSR were better investments over the longer term since low CSR companies were more likely to be involved in business activities that were unsustainable.

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Appendix

Questionnaire of Survey in 2003: Attitudes of Managers toward CSR and Enterprise Restructuring

Interviewer Name:	Telephone:	Date of Interview:

I. ENTERPRISE BACKGROUND (Please tick ☑ with the right answer)

1. **Name of Enterprise:**	2. **Industrial Sector:**
3. **Location of Enterprise:** Province City	
4. **Start-up Date:**	
5. **Enterprise Size:** Large☐, Medium☐ , Small ☐。	
6. **Supervisory Authority:**	
1) State Asset Management Commission ☐	4) Local government ☐
2) Ministry or Industrial Bureaus at central level ☐	5) No supervision ☐
3) Provinince or Industrial Bureaus at provincial level ☐	6) Others (specify)
7. **Ownership**	
1) State-owned ☐	2) Shareholding ☐
3) Collective-owned ☐	4) Private ☐
5) Cooperative shareholding ☐	6) Other_______ ☐
8. **If enterprise is currently not state-owned, was it state-owned one in the past?** Yes ☐, No ☐.	
9. **If your company is state-owned, when did the change in ownership occur?** year_______	

II. ATTITUDES OF EXECUTIVE AND MANAGERS TOWARDS CSR

10. To what extent, do you agree or disagree with the following statements ? (Please mark your response on a scale of 5 to 1, where 5 is strongly agree, 4 agree, 3 neutral, 2 disagree and 1 is strongly disagree.)

	5	4	3	2	1
1) Engagement of a firm in socially responsible actions doesn't conflict with pursuit of profit	☐	☐	☐	☐	☐
2) Business will participate more actively in social responsibility in prosperous economic times than in recession.					
3) A business that wishes to capture a favourable public image will have to show that it is socially responsible	☐	☐	☐	☐	☐
4) There is no difference between involvement of a firm in socially responsible activities and public relations positioning	☐	☐	☐	☐	☐
5) Business already has too much social power and should not engage in social activities that might give it more	☐	☐	☐	☐	☐
6) If business is more socially responsible, it will avoid additional regulations of the economic system by government, and reduce restricts in firm's operation	☐	☐	☐	☐	☐
7) Involvement by business in improving its local community's quality of life will also improve long run profitability	☐	☐	☐	☐	☐
8) A firm perceived as high in social responsibility can face relatively low level of industrial conflicts	☐	☐	☐	☐	☐

9) High social responsibility can put a firm at an economic disadvantage compared to less socially responsible one	❐ ❐ ❐ ❐ ❐
10) Socially responsible activities can improve a firm's standing with bankers, and access sources of capital	❐ ❐ ❐ ❐ ❐
11) Socially responsible activities can improve a firm's standing with investors, and reduce financial risk	❐ ❐ ❐ ❐ ❐

11. To what extent, do stakeholder groups have impact on your firm's public image/reputation? (Please mark your response on a scale of 5 to 1, where 5 is to a great extent 4 to some extent, 3 not really, 2 not at all, 1 unsure)

	5 4 3 2 1		5 4 3 2 1
1) Shareholder	❐ ❐ ❐ ❐ ❐	5) The general public	❐ ❐ ❐ ❐ ❐
2) Customers	❐ ❐ ❐ ❐ ❐	6) Local communities	❐ ❐ ❐ ❐ ❐
3) Employees	❐ ❐ ❐ ❐ ❐	7) Governments	❐ ❐ ❐ ❐ ❐
4) Business partners	❐ ❐ ❐ ❐ ❐		

12. What relationship does your firm have with the stakeholder groups? (Please mark your response on a scale of 5 to 1, where 5 is the best, 4 better, 3 good, 2 bad and 1 worse.)

	5 4 3 2 1		5 4 3 2 1
1) Shareholder	❐ ❐ ❐ ❐ ❐	5) The general public	❐ ❐ ❐ ❐ ❐
2) Customers	❐ ❐ ❐ ❐ ❐	6) Local communities	❐ ❐ ❐ ❐ ❐
3) Employees	❐ ❐ ❐ ❐ ❐	7) Governments	❐ ❐ ❐ ❐ ❐
4) Business partners	❐ ❐ ❐ ❐ ❐		

13. In your opinion, what enterprise behaviour is more socially responsible in the context of the current economic development in China? (Please mark your response on a scale of 5 to 1, where 5 is strongly agree, 4 agree, 3 neutral, 2 disagree and 1 is strongly disagree.)

	5 4 3 2 1
1) Creating value for company's shareholders	❐ ❐ ❐ ❐ ❐
2) Provision of a healthy and safe working environment for employees	❐ ❐ ❐ ❐ ❐
3) Provision of quality products and services for consumers	❐ ❐ ❐ ❐ ❐
4) Doing business with its partners with integrity	❐ ❐ ❐ ❐ ❐
5) Actively participating in social benefit activities	❐ ❐ ❐ ❐ ❐
6) Improving environmental quality and pollution control	❐ ❐ ❐ ❐ ❐
7) Complying with state law, and being a good tax payer	❐ ❐ ❐ ❐ ❐

14. In your opinion, what enterprise behaviour is more socially responsible in the restructuring activity? (Please mark your response on a scale of 5 to 1, where 5 is strongly agree, 4 agree, 3 neutral, 2 disagree and 1 is strongly disagree.)

	5 4 3 2 1
1) Announcements of restructuring decision in very early stage	❐ ❐ ❐ ❐ ❐
2) Seeking inputs from employees, trade unions and local communities	❐ ❐ ❐ ❐ ❐
3) Open communication with employees in the process of the restructuring	❐ ❐ ❐ ❐ ❐
4) Continuing to offer salary and benefits for a period time in order to allow reasonable time for job search	❐ ❐ ❐ ❐ ❐
5) Providing severance benefit package for voluntary early retirement	❐ ❐ ❐ ❐ ❐

6)	Providing internal and/or external outplacement service such as training for employability, job counselling, financial planning and information on government benefits	❒	❒	❒	❒	❒
7)	Organizing the transfer of redundant and laid-off employees to other units, giving them priority for job vacancies	❒	❒	❒	❒	❒
8)	Assisting employees in obtaining government benefits such as extended unemployment benefits and job training support, job search allowance	❒	❒	❒	❒	❒
9)	Encouraging and supporting employees to start up their own business	❒	❒	❒	❒	❒

15. What are areas of CSR which your firm has been involved over the past three years? (Please choose all it may apply)

	Yes	No		Yes	No
1) Organizing or participating in public welfare activities	❒	❒	6) Contribution to vulnerable group	❒	❒
2) Encouraging employees' voluntary welfare programmes	❒	❒	7) Donation to charitable and public welfare organizations	❒	❒
3) Improving employee welfare (facilities and benefits)	❒	❒	8) Contribution to cultural and literary programmes	❒	❒
4) Active contribution of tax to government	❒	❒	9) Other (specify)	❒	❒
5) Improving pollution control / environment impact	❒	❒			

III. ENTERPRISE RESTRUCTURING

16. Please indicate the reforms which your enterprise has ever undergone

Reform Events	Started year	Ended Year
1. Factory director responsibility system		
2. Contract responsibility system		
3. Leasing system		
4. Corporation system		
5. Stockholding system		
6. Ownership restructuring under Company Law		

17. What is the legal form of your company after restructuring?

1) Wholly state-owned company	❒	4) Cooperative shareholding company	❒
2) Limited liability company	❒	5) Private company	❒
3) Company limited by shares	❒	6) Other (please specify)	❒

18. In the process of restructuring, did the government get involved in the decision-making strategy and implementation?

1) Controlled by government or supervisory authority of company, and implemented by enterprise.	❒
2) Driven by market force, determined and implemented by enterprise with some government intervention	❒
3) Determined and implemented by enterprise without government involvement, adopting approaches such as merger & acquisition, etc.	❒
4) Determined by Superior company, and implemented by subsidiary	❒

19. In the process of enterprise restructuring, to what extent did the employees and their

Committee get involved?		
	Yes	No
1) Executive management sought input prior from employees to determining implementation action.	❐	❐
2) Executive management communicated restructuring strategies and measures with employees in time	❐	❐
3) Executive management kept employees involved in the whole restructuring process	❐	❐
4) After restructuring, executive management collaborated with employees and their committee in solving problems such as redeployment of redundant workers.		
5) Executive management determined needs/actions with little input from employees.	❐	❐

20. In the process of restructuring, to what extent, did the local community where your enterprise operates get involved?		
	Yes	No
1) Seeking suggestions and advice from the local government authority before implementation	❐	❐
2) Holding meetings with the local government authority during the restructuring process	❐	❐
3) Only keeping the community informed of the restructuring event	❐	❐
4) No involvement at all	❐	❐

21. To what extent was the restructuring/downsizing information communicated to employees?		
	Yes	No
1) Announcing restructuring/downsizing in very early stage through meetings and media such as publication, radio, internet, email, etc.	❐	❐
2) Informal briefing to employees by supervisors and managers in charge of restructuring/downsizing	❐	❐
3) Executives and senior managers were always available to answer questions and explain issues	❐	❐
4) Information was only available to senior managers, not to employees before implementation	❐	❐
5) No communication at all	❐	❐

22. Did your company take any of following initiatives during the restructuring?					
	Yes	No		Yes	No
1) Upgrading of existing production line	❐	❐	6) Accreditation of ISO14000	❐	❐
2) Opening of new plant	❐	❐	7) Closure of at least one existing plant	❐	❐
3) Successful development of major production line	❐	❐	8) Discontinuation of at least one production line	❐	❐
4) Increasingly investment in R&D	❐	❐	9) Reducing investment in R&D	❐	❐
5) Accreditation of ISO9000	❐	❐	10) Reducing expenditures on environmental improvement	❐	❐

23. If your company resorted to downsizing, please indicate how many employees were downsized over restructuring period (in percentage)?			
1) Less than 10%	❐	4) 10−20%	❐
2) 20−30%	❐	5) more than 30	❐

24. What social support programmes were provided for the terminated and redundant employees?

	Yes	No
1) Continuing to offer salary and benefits for a period time in order to allow reasonable time for job search	❒	❒
2) Offering severance package for voluntary early retirement	❒	❒
3) Providing internal and/or external outplacement service such as training for employability, job counselling, financial planning and information on government benefits	❒	❒
4) Organizing the transfer of redundant employees to other units, giving them priority for job vacancies	❒	❒
5) Encouraging and supporting employees to set up their own business	❒	❒
6) Assisting employees in obtaining government benefits such as extended unemployment benefits and job training support, job search allowance	❒	❒

25. How did your firm deploy the terminated and redundant employees?

	Yes	No		Yes	No
1) Placement within its own firm	❒	❒	5) Placed at re-employment service centre	❒	❒
2) Early retirement	❒	❒	6) Self-employment or start-up own business	❒	❒
3) Unemployment, awaiting for placement	❒	❒	7) Other (please specify)	❒	❒
4) Transfer to other companies	❒	❒			

26. To what extent, did the labor disputes happen in your firm during restructuring ?

	Yes	No
1) Disputes over lack of communication with employees in objectives and strategies of restructuring in advance	❒	❒
2) Disputes over mass layoff without taking any alternative approaches	❒	❒
3) Disputes over employees being fired without offering welfare payment	❒	❒
4) Disputes over corruption issue in the process of restructuring	❒	❒
5) Disputes over the promise not being materialized to terminated employees	❒	❒

27. Which social functions that your firm bore in the past have been spun off after restructuring?

	Yes	No		Yes	No
1) Education	❒	❒	4) Medical care service	❒	❒
2) Pension benefits	❒	❒	5) Public welfare facilities (sports, recreational centre, etc)	❒	❒
3) Housing service	❒	❒	6) Other (specify)	❒	❒

28. Please indicate how the equity was allocated to each of the following categories at the time of restucturng and after restructuring (2002) (in percentage) ?

	In restructuring	2002
1) National government or state asset management commission	%	%
2) Provincial government or provincial asset management commission	%	%
3) Municipal government or municipal asset management commission	%	%
4) Supervisory authority of company	%	%
5) Workers in the company	%	%

6)	Managers in the company	%	%
7)	The company itself	%	%
8)	Individuls outside the company	%	%
9)	Other legal entities	%	%

29. If there is important change in the distribution of equity between restructuring time and 2002, what was the nature of the change in the distribution of equity?			
1) Shares were sold to the public	❐	4) State shares were transferred to a new corporate of administrative entity	❐
2) More shares were distributed to workers and managers	❐	5) Other (please specify)	❐
3) Shares were granted to managers as an incentive payment	❐		

30. Does your firm own any assets that were formally classified as state-owned assets? Yes ❐ No ❐. If yes, which of the following best describes the process through which company acquired these assets?

	Yes	No		Yes	No
1) Assets were created by investment from enterprise funds of SOE; assets were later determined to belong to company	❐	❐	6) Company purchased part of assets from SOE after it went bankrupt	❐	❐
2) Government distributed assets to the company, its managers, or its workers without payment	❐	❐	7) Company purchased a still operating SOE	❐	❐
3) Government distributed assets to the company, its managers, or its workers at a concessiionary price	❐	❐	8) Company purchased part of assets of a SOE	❐	❐
4) Government distributed assets to the company, its managers, or its workers at a market price	❐	❐	9) Other (specify)	❐	❐
5) Company purchased a SOE after it went bankrupt	❐	❐			

31. Does your company issue stocks? Yes ❐, No ❐. If yes, what proportion of your company's outstanding stocks is owned by (in percentage)?			
1) Individuals outside the firm	%	4) Managers of the firm	%
2) Employees of the firm	%	5) Government	%
3) Insitutions	%	6) Other (specify)	%

32. Does your company excise the voting rights for some shares held by workers of the company? Yes ❐, No ❐. If yes, what is the voting method used?			
1) One share, one vote	❐	3) One person, one vote	❐
2) Ordinary shares have one vote, preferred shares have more than one votes	❐	4) Other (specify)	❐

33. What approaches were employed in your enterprise restructuring?					
1) Consolidation	❐	5) Tender-off	❐	9) Reorganization	❐
2) Acquisitions	❐	6) Divestiture	❐	10) Leasing/contract	❐
3) Merger	❐	7) Selling off	❐	11) Bankruptcy	❐
4) Takeover	❐	8) Spin-offs	❐	12) Downsizing	❐

34. To what extent, did your firm attain restructuring goals? Please mark your response on a scale of 5 to 1, where 5 to a great extent, 4 to some extent, 3 not really, 2 not at all and 1 unsure					
	5	4	3	2	1
1) Reduce debt	☐	☐	☐	☐	☐
2) Improve product quality and customer service	☐	☐	☐	☐	☐
3) Increase productivity	☐	☐	☐	☐	☐
4) Increase profitability	☐	☐	☐	☐	☐
5) Reduce costs and expenses	☐	☐	☐	☐	☐
6) Reduce bureaucracy and administration	☐	☐	☐	☐	☐
7) Improve autonomy and decision-making	☐	☐	☐	☐	☐
8) Increase sales and market share	☐	☐	☐	☐	☐
9) Increase competitive advantage	☐	☐	☐	☐	☐
10) Achieving the goal of reducing redundant staff and increasing efficiency	☐	☐	☐	☐	☐

IV. EXTERNAL ENVIRONMENT

35. Who are your firm's main competetors? (Please select maximum 3 items)			
1) Township and village enterprises	☐	4) Private enterprises	☐
2) State-owned enterprises	☐	5) Imported product	☐
3) Newly established state-owned enterprises	☐	6) Other (specify)	☐

36. How problematic are these factors for the operation and growth of your business? Please mark your response on a scale of 5 to 1, where 5 for major obstacle, and 1 no obstacle)											
	5	4	3	2	1		5	4	3	2	1
1) Lack of autonomy	☐	☐	☐	☐	☐	6) Tax regulations	☐	☐	☐	☐	☐
2) Brain drain	☐	☐	☐	☐	☐	7) Business licensing	☐	☐	☐	☐	☐
3) Policy instability / uncertainty	☐	☐	☐	☐	☐	8) Infrastructure (electricity, water, roads, and land)	☐	☐	☐	☐	☐
4) Unhealthy Financial system	☐	☐	☐	☐	☐	9) Other (specify)	☐	☐	☐	☐	☐
5) Exchange rate											

37. How problematic are these different financing issues for the operation and growth of your business? Please mark your response on a scale of 5 to 1, where 5 for major obstacle, and 1 no obstacle)											
	5	4	3	2	1		5	4	3	2	1
1) High interest rates	☐	☐	☐	☐	☐	4) Collateral	☐	☐	☐	☐	☐
2) Access to long-term bank loans	☐	☐	☐	☐	☐	5) Access to equity / investors/partners	☐	☐	☐	☐	☐
3) Access to connections with banks/financial institutions	☐	☐	☐	☐	☐	6) Other (specify)	☐	☐	☐	☐	☐

38. How significant are your firm's overdue payables (Please mark your response on a scale of 5 to 1, where 5 for substantial, and 1 non owed)											
	5	4	3	2	1		5	4	3	2	1
1) to central government	☐	☐	☐	☐	☐	4) to banks	☐	☐	☐	☐	☐
2) to local government	☐	☐	☐	☐	☐	5) to employees	☐	☐	☐	☐	☐

3) to utilities	❒ ❒ ❒ ❒ ❒		

39. How significant are other organizations overdue payables to your firm (Please mark your response on a scale of 5 to 1, where 5 for substantial, and 1 non owed)			
	5 4 3 2 1		5 4 3 2 1
1) central government	❒ ❒ ❒ ❒ ❒	4) new SOEs	❒ ❒ ❒ ❒ ❒
2) local government	❒ ❒ ❒ ❒ ❒	5) banks	❒ ❒ ❒ ❒ ❒
3) old SOEs	❒ ❒ ❒ ❒ ❒		

V. CORPORATE GOVERNANCE STRUCTURE

40. Is your enterprise part of a corporate group? Yes ❒, No ❒. If Yes, how many firms are there in the group (or holding company) ?________. In what year was the group established? _______. Was your firm an original member of the group? Yes ❒, No ❒. If No, in what year, did your firm become a member?_______

41. Do you have legal subsidiaries? Yes ❒, No ❒, If Yes, how many? ______. Of these subsidiaries, how many are factories ________, how many are labour service companies_______, Is one of these subsidiaries the traditional SOE from which the corporation was formed? Yes ❒, No ❒ .

42. Is there Board of Directors in your company? Yes ❒, No ❒. If Yes, when was it established? In the year__________

43. How was Board of Directors set up?			
1) Shareholders' Meeting	❒	4) Decided by Manager (Director)	❒
2) Delegated by supervisory authority of company	❒	5) Nominated by company and decided by its supervisory authority	❒
3) Decided by mother company	❒		

44. Is there Supervisory Board in your company? Yes ❒ , No ❒. **If Yes, in which year did the company first have individual supervisors?**__________

45. How was Supervisory Board set up?			
1) Shareholders' Meeting	❒	3) Board of Directors	❒
2) Delegated by supervisory authority of company	❒	4) Decided by mother company	❒

46. How does your company appoint or dismiss Vice-President (Deputy Director) and branch leaders?			
1) Decided by the Director-General	❒	5) Decided by shareholders' meeting	❒
2) Elected by management	❒	6) Nominated by Director-General, and decided by its supervisory authority	❒
3) Decided by its supervisory authority	❒	7) Position competition	❒
4) Decided by communist party	❒	8) Other (Please specify):	❒

VI. MANAGER'S PROFILE

47. Name:	**48. Age:**	**49. Sex: Male ❒ , Female ❒**

50. Professional Title: 1) Advanced level ❒, 2) Medium level ❒, 3) basic level and lower ❒。

51. Education:		**52. Educational Subject:**	
1) Graduate and above ❒	4) Secondary education ❒	1) Polytechnic ❒	4) Social science ❒
2) University ❒	5) Elementary education ❒	2) Economics ❒	5) Other ❒

3) College ❐		3) Management ❐	

53. When were you appointed as a director of the company? In the year________

54. Did you have the formal appointment certificate when you took your office as Manager General? Yes ❐, No ❐. **If Yes, which organization issued it?**			
1) Board of Directors	❐	4) Communist party	❐
2) Supervisory authority of company	❐	5) Other	❐
3) Employees' Committee	❐		

55. How were you appointed director of your enterprise?			
1) Nominated by the enterprise, and approved by the surpervisory authority of the entperise	❐	5) Elected by the Employees' Reprentative Committee	❐
2) Designated by the top authority	❐	6) Post competition	❐
3) Appointed by board of directors	❐	7) Other (Please specify):	❐
4) Decided by shareholders' meeting	❐		

56. What did you do before your current position?			
1) Worker in the company	❐	4) Civil servant	❐
2) Deputy Director or Manager	❐	5) Other	❐
3) Vice-president (Deputy General Manager) from other company	❐		